# ECONOMIC OVERVIEW

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# HEARINGS

BEFORE THE

## COMMITTEE ON APPROPRIATIONS
## UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

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## SPECIAL HEARING

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# ECONOMIC OVERVIEW FOR FISCAL YEAR 1983

WEDNESDAY, FEBRUARY 24, 1982

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
*Washington, D.C.*

The committee met at 9:30 a.m., in room 1114, Everett McKinley Dirksen Senate Office Building, Hon. Mark O. Hatfield (chairman) presiding.

Present: Senators Hatfield, McClure, Garn, Abdnor, D'Amato, Mattingly, Specter, Proxmire, Stennis, Byrd, Eagleton, Chiles, Burdick, Leahy, Sasser, DeConcini, and Bumpers.

## COMMITTEE ON APPROPRIATIONS

### MEMBERS' OPENING STATEMENTS

#### DESIGNATION OF WITNESSES

Chairman HATFIELD. Our hearing will come to order.

Today this committee renews a long tradition, abandoned for a time until last year, with the beginning of 4 days of economic overview hearings. No Members of Congress master the Federal budget more comprehensively than members of this committee. We examine every single one of the thousands of individual accounts in the Federal budget. The purpose of these hearings is to insure that we do not lose sight of the big picture in this mass of detail.

Today and tomorrow we will hear from the President's principal economic spokesmen. Dr. Murray Weidenbaum, Chairman of the Council of Economic Advisers, will open our hearings today, to be followed by OMB Director David Stockman. Treasury Secretary Donald Regan will round out this threesome as our opening witness tomorrow. Following Secretary Regan, we will hear from Congressional Budget Office Director Alice Rivlin, who will unveil CBO's reestimate of the President's budget, which was prepared this year at my request.

Next week we will turn to monetary policy, and hear from Paul Volcker, Chairman of the Board of Governors of the Federal Reserve.

We have also asked nongovernment economists to give us predictions on the economy as well as their advice on the appropriate fiscal course for the Congress to adopt.

A distinguished group of experts will appear, including three former chairmen of the Council of Economic Advisers, Dr. Herbert Stein, Dr. Alan Greenspan, and Dr. Charles Schultze. In addition, Louis Kelso, chairman of Kelso and Company, and MIT Professor Lester Thurow will testify.

## ECONOMIC ILLS PLAGUING NATION

These hearings open at a time when the country is enduring highly disturbing economic conditions. No one has been truly satisfied with the economy for a decade. Our citizens have been buffeted alternately by record inflation, record interest rates, and deep recession, or at times all three. The question in my mind is when will the bad news end? When will we turn the corner to a stable prosperity? President Reagan brought us predictions of better times ahead if we would only adopt his economic program. We did, and although no one expects miracles overnight, the initial returns, except on the inflation front, are not encouraging. Despite the unprecedented spending cuts enacted last year, we still face unacceptable Federal deficits.

The Appropriations Committee has a marvelous historical record of holding down Federal spending. In 37 of the last 39 years, appropriations have been under the President's request. Unfortunately, one of the 2 years we did not reach this target was fiscal year 1982. Nevertheless, I am very proud of this committee's performance last year.

## PROPOSED BUDGET LEVELS

Our figures were far below President Reagan's March budget request, but we could not meet his September proposal of a 12-percent across-the-board cut in nondefense discretionary programs. However, fiscal year 1982 nondefense discretionary outlays have been held below those of the previous year, and in fact, are projected to be below even the level provided in fiscal year 1980.

If inflation is considered, this is a 21-percent reduction in real terms from the levels provided just 2 years ago.

## REDUCTIONS IN FISCAL YEAR 1983 NONDEFENSE ITEMS

For fiscal 1983, the administration has proposed even further reductions. Outlays from budget authority provided for fiscal year 1983 for nondefense discretionary programs are proposed to be reduced nearly 35 percent for this year. Controllable defense spending, on the other hand, will be increased by more than 14 percent, and "relatively uncontrollable" outlays will increase 7½ percent.

The net effect of this budget plan will be to reduce new nondefense outlays to only 6 percent of the Federal budget. Ninety-four percent of fiscal year 1983 Federal outlays will be for the military, entitlements, prior year appropriations, debt service, and other activities locked into revolving accounts.

This is the same 6 percent of the budget which this administration has counted on for so much for the progress in reducing the size of the Federal budget. Now that it has been pared down to such a miniscule fraction of the budget, it is not surprising that we now hear that the budget cannot be balanced within the next several years.

I believe the solution will only be found by restructuring the uncontrollable portion of the budget, and by adopting a more sane defense policy.

### HEARING PROCEDURE DETAILS

Before recognizing our distinguished ranking member, I would add two procedural details. The only two hearing rooms large enough to accommodate this committee were unavilable this week. We have room for only 21 chairs around the dais. I know our members will be tolerant of this inconvenience.

Second, in order to provide every member a chance to question our witnesses, each member will be limited to 5 minutes in the first round of questions. When the yellow light goes on, you will have only 1 more minute for questions. The red light signifies that 5 minutes are up.

Senator Proxmire.

### STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman, I am delighted that this committee has once again scheduled economic overview hearings. We have held such hearings in the past, as you indicated, but we suspended them for several years. I think this was a mistake because there is no question that the budget has a profound effect on the economy and we should have that firmly in mind when we act on appropriation requests.

Before we begin to work on the details of the President's fiscal year 1983 budget, we should determine exactly where that budget fits into the economic scheme of things—how it will interact with and affect inflation, unemployment and interest rates.

We were told by our very first witness last year, Secretary of the Treasury Regan, that "The administration has two major goals: A major reduction in inflation and a resurgence of economic growth." We are getting inflation under control to some extent but we seem to be further than ever from a resurgence in economic growth.

I am particularly concerned about the effect on the economy of projected budget deficits totaling $464.1 billion between fiscal years 1982 and 1987.

I am concerned because I agree with Budget Director Stockman, who told the committee last year:

> Fiscal policy has produced chronic, perpetual deficits . . . . These permanent deficits have engendered continuous increases, inflationary expectations, and consequently large increases in market interest rates.

Of course it is excessively high interest rates that have been a prime factor in the economy's decline over the past few months.

If ever there was an interest rate recession, this is it.

## REDUCTION IN INFLATION RATE

Thanks to this brutal recession we have witnessed a significant reduction in the inflation rate over the past year. But what will happen when the economy begins to expand once more? I fear that without a concurrent elimination of the huge deficits that have been projected, our attention will be forced to shift once more from the tragedy of high unemployment to an equally tragic resurgent and soaring inflation rate.

What hope does this committee have for getting Federal spending under control? I cite the same figures and the same percentages as the chairman of the committee has mentioned but look at them in a slightly different way.

I regret to say that the President's budget proposals give us very little hope.

If we rubber-stamped the President's 1983 budget request, the relatively uncontrollable portion of a $725.3 billion outlay budget, and I am including defense spending in that relatively uncontrollable category, would rise from about 90 percent to an incredibly high 94 percent. This committee would be faced with the prospect of trying to cut into a $91.5 billion deficit with only about $46.3 billion in discretionary nondefense spending to work with.

Since I endorse Secretary Regan's statement to this committee last year that spending restraint is essential and that "it is particularly essential to alter the built-uncontrollables" I view with dismay this spectre of a Federal spending juggernaut that is increasingly out of control.

Mr. Chairman, I just returned from my State, as many of us have, and I have found almost nobody who feels that this budget which the President has presented to us will work, and I'm not just speaking about Democrats, but about Republicans as well, business people as well as labor people, farmers as well as a lot of other very, very thoughtful and intelligent people. When I come back here to talk to national leaders, they agree. They cannot see how we can make economic progress when we have an interest rate recession caused in great degree by very large Federal borrowing and when we are going to increase that borrowing.

The clash of a conservative monetary policy, which I support, with explosive fiscal policies has given us these high interest rates that are devastating to the home building industry, the automobile industry, and small business generally.

I do look forward to the opportunity to question the administration's economic team as well as eminent private sector economists in the days ahead and I hope that together we can find some way to reduce the administration's projected budget deficits.

Thank you.

Chairman HATFIELD. Thank you very much. Senator Garn?

## STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Just very briefly: As I have watched the news media and I watched the critics of the President's budget, watched Congress performance in general, I am very sadly dismayed by what I think is an unprecedented level of hypocricy and demagoguery on the part of Congress. And I think it should be stated that it is a fact of the Constitution that no President has ever spent a dime not appropriated by the Congress of the United States.

I have never seen so many people in both parties running for cover trying to find someone else to blame. We get that every day in the Banking Committee: "It is all Paul Volcker's fault. If you do something differently or we put farmers or businessmen on the Federal Reserve Board that will solve the problem," or "Ronald Reagan has done it all in 1 year."

The previous 30 or 40 years has nothing to do with it.

I make the point strongly that the Constitution says that only Congress appropriates money. So if we don't like the trillion dollar debt, if we don't like the $91 billion deficit added to it; rather than trying to get somebody else to blame, I would suggest the American people ought to recognize that only Congress appropriates money.

The President can recommend the budget, he can beg, plead, shout, yell, threaten, he can veto, but he can't spend a dime not appropriated by this body.

I would suggest that the fault lies through several administrations on both Republicans and Democrats who appropriated this money over the years until we are willing to quit looking for someone else to blame rather than ourselves and come to grips with the real problem. It will not be solved because when you have a situation where both this administration and this Congress has been unwilling to face the growth in the entitlements program; cuts, as the chairman outlined, are primarily in discretinary programs. When you have a little more than 50 percent of the budget increasing at 16 percent per year, a little less than one-half of the budget cut at 8 percent per year, you don't have to be too bright, you don't have to be an economist to put a calculator in that and see that that gap will grow. If you did away with the third year of the tax cut, cut the tax in half next year, you put a calculator in that and it still won't balance. It simply will not balance until we have the courage to say that growth in the entitlement program must be cut.

### SLOWDOWN IN GROWTH

I want to be very clear. I am not advocating we cut social security or veterans pension, but I am saying we must have the political courage to say that growth must be slowed. From my capacity in the Banking Comittee, looking at high interest rates for the long-term money market managers, they are not looking at 1983 and 1984 as out years, they are looking at 1988, 1989, 1990, and 1991 and they are not going to be stupid enough to continue to borrow short and lend long when they see nothing happening in those out years with that tremendous growth in the uncontrollable part of the budget. And until we start sending that signal, interest rates will remain high even if we balance the budget in 1982. I think everybody would be surprised that interest rates were still high because again the long-term money market managers are looking at that period of time many years down the road, Congress has not been willing to address that.

We have held all these hearings, Mr. Chairman, the Banking Committee on monetary policy and interest rates; the more that I listen in that committee, the more convinced I become that we simply have to slow down that growth and that uncontrolled part of the budget, or we are kidding ourselves with all of these other short-term fixes.

I hope, Mr. Weidenbaum, the administration will be willing to recognize that. I hope Congress, Democrats and Republicans alike, will recognize that this economy is in such dire straits that we cannot be the Dutch Boy at the dike, sticking our fingers in the leaks and trying to jam it up, unless we are willing to tell the American people that growth and those entitlements and those uncontrollables has to be slowed down.

Thank you, Mr. Chairman.

## STATEMENT OF SENATOR STENNIS

Chairman HATFIELD. Senator Stennis?

Senator STENNIS. Mr. Chairman, I first want to thank you especially for calling these hearings. I remember last year that you held in this committee some of the most valuable hearings, I think, that were held the entire year and contributed to a good year, and positive accomplishments, too. But in the process of last year, our Appropriations Committee almost lost the ballgame.

I want to thank the chairman and the Members that helped for what they did to try to save our roles last year, and for making a fight, I hope it will be unanimous, eternal, to preserve the role of our committee this year and if we have to give, let's talk it over and think it over, maybe both the Budget and Appropriations Committees can yield a little.

I don't say that by way of complaint. I think it is a matter of self defense.

Since we left here, gentlemen of the committee, I conferred with a great many knowledgeable people in my own State. They are beginning to believe that all estimates are off and we have to almost join them. I know that all the jokes about all this are old and worn out and not funny anymore, and I can't say what all is the matter.

I remember way back hearing about a football player who had been put in to substitute. They smothered him on every play and the coach jerked him out and the coach said, "Jim, what in the world was the matter out there?" and he says, "Coach, ain't nobody blocking nobody."

We are bound to get into that predicament ourselves. But through hearings like this, I believe that we can find the way out. These amazing figures here cited by Senator Proxmire, as I understood him, he said that there was only $46 billion, to play on in reducing the deficit unless we go into entitlements, we have just $46 billion to play on.

Even if we took all of it, we still have this deficit.

I think we have got to keep running that rabbit rather than going off in side issues to bring this thing about. I just hope we go right down the road and make those this year one way or another. I think I will vote for my part all right.

I don't want to sound like I am complaining, I feel like we can get something constructive here. I ask unanimous consent that the rest of my statement be put in the record.

Chairman Hatfield. Thank you.

[The statement follows:]

### STATEMENT OF SENATOR JOHN C. STENNIS

Mr. Chairman, I appreciate this opportunity to again this year review our economy and have the opportunity to hear and question the distinguished gentlemen who are appearing before the committee today. Certainly the highest priority for our Government is the restoration of economic stability and reviving the growth in our economy, and these hearings are eseential to our full understanding of the President's fiscal program and the impact this program will have on the economy.

I know you share with me a concern for the tremendous economic cost to the Nation of unemployment and the underutilization of our Nation's manufacturing industries. Clearly we have a responsibility to join with the President in seeking a solution to these economic problems. In this regard, I believe that at the heart of this economic situation is the problem of high interest rates. They have persisted now for more than 2 years at unprecedented levels. Last year before this committee, during similar hearings which the chairman conducted, I expressed my concern for the great harm that was coming to our economy from high interest rates. I asked each of the officials who appeared before us if there was a way that these interest rates could be reduced and brought down to a level which would allow the economy to recover.

I recall that the response was almost uniform that if we enacted the President's economic recovery budget and tax program the financial market would respond accordingly and interest rates would fall quite dramatically. However, as we all know, events didn't turn out quite as well as expected and we find ourselves now in a deep recession: unemployment is high, businesses are failing, business investment is low, and interest rates are intolerable. In particular, long-term interest rates, which are so vital to the building industry, have steadfastly remained at extremely high levels. These rates have in effect induced a depression condition in that industry which is so basic to our way of life.

High interest rates which have persisted for over 2 years have taken a terrible toll in nearly every sector of our economy. In addition to the interest sensitive farming and automobile industries which have suffered greatly through this period, the overall economy is now in a deep recession. The lack of production and high unemployment have served to reduce revenues while increasing unemployment and assistance payments. In short, Mr. Chairman, unless the economy recovers, and recovers strongly, we will continue to experience these high Federal deficits, high interest rates, and inflation. Somehow we must break the back of this trend.

I recently toured through my State and visited county by county to witness the declining economic conditions in my State. In encountered solid, well-managed firms that were laying off 80 and 90 workers. Some of our strongest industries, in which I have a high respect for their management, are failing under the heavy burden of high interest rates. I believe, Mr. Chairman, that something must be done to remove this burden. I'm not certain myself as to what is required; I am definitely not an expert in these matters. However, as a practical observation, I believe that we should give consideration to some kind of program to stimulate the economy.

In the past, the housing industry has helped pull us out of these recessions. Perhaps this kind of program is needed now. It is my hope in these hearings that the spokesmen who appear here as witnesses will address themselves to this question of what course we should pursue to get the economy going again. I would like for each of the witnesses to address a short-term plan for reducing interest rates and brining about overall economic recovery in the next 3 or 4 months.

### STATEMENT OF SENATOR McCLURE

Chairman HATFIELD. Senator McClure?

Senator MCCLURE. Thank you very much, Mr. Chairman, First of all, I concur in what has been said here. I particularly want to underscore my agreement with what Senator Garn said about the problems that we confront. And I would like to take a line out of what our chairman has said from time to time in the past and underscore it. It is not the failure of the appropriations process that is causing our problem. I think a good example of that can be shown in the shape of this budget that we are experiencing now, 54 percent of it is outside the control of the Appropriations Committee, over one-half of all expenditures are now mandated by a statute that did not flow through and is not subject to the appropriations process. And it is precisely in that area that our problems lie.

We all know that. It isn't just the money managers in Wall Street that have made the judgment about the courage and commitment of the Congress. There are a lot of other people around the country that know that we are the problem.

They are going to levy that judgment on us at the polls this fall if we fail to meet that challenge. And I would agree with Senator Garn, too, that if by some magic we balance the budget this year but did nothing with out year growth interest rates still would not come down to reasonable levels. Managing the budget deficit is important, certainly in 1983 budget terms. But the more important task lies in changing the trend line, getting that bent downward instead of seeing it continue upward. And that is the real challenge that this Congress will face.

### INTEREST RATES

Interest rates are eating us alive.

When I was home over the break, I visited with a number of CPA's who have a number of clients. They are a good place to find out what is happening. They don't tell you exactly who their clients are, which ones they are speaking of, but they can tell you a broad spectrum of economic activities as it deals with the farmers, the ranchers, the small businessmen up and down the main streets and they are telling me, Dr. Weidenbaum, that they don't have time, that we really have a fiscal economic crisis in this country today that doesn't yield itself to the idea that by the end of this year or sometime next year it is going to be better. They are telling me they have a number of clients who will be bankrupt in 30 to 60 days, farmers who cannot now go out and borrow the capital necessary to put their crops in the ground, small businessmen that cannot carry the inventory any longer at the interest rates that we have today.

And there is a critical need to get interest rates down now.

I have some friends here in the Senate who suggested we have credit controls again as though it is that easy. I had one suggest we mandate a given interest rate. I asked what interest rate they would like, and they thought 12 percent would be about right and I said, why not 10, or 8, if it's that easy, we will pass a statute. If it was that easy, we would have done it before. Obviously it isn't that easy because it lies in the growth of the so-called entitlements, the formula programs, and there isn't anyone who really says that is going to be easy.

I think we all know it is going to be tough.

I want to commend at least a couple of people around here who have been talking about that for a long period of time. Senator Hollings, a year ago, was talking about the necessity to curb the growth in the social security program and he got clobbered in a political sense.

How many around this table today have the courage, really, to address that question in a meaningful way? How many of the Members of the Senate and House of Representatives who are calling for some kind of restraint really have the courage to go out and tell their constituents that the social security system is in trouble, that the growth in benefits has to be curbed?

I sat and talked to a retired Member of the Senate whose income under retirement is now greater than our pay. I talked to a retired member of the military who within another year will be getting more in retirement pay than he got in active duty. I talked to people who are insisting that they have escalation in their benefit levels because of the cost of living and inflation and then talked to people who have negotiated volume wage settlements that call for 10 percent rollbacks. I think it is high time to look at the kind of things that Senator Hollings was talking about in freezing benefit levels for a period, give us a little breathing room to make the adjustments that are necessary. And I believe that we are very, very close to total success but even closer to total failure.

If we just do something to move now, to convince people in this country that Congress has an unusual quantum of courage and the unusual lack of political demagoguery and appeal for special interests, then I think interest rates would come down and interest rates are the problem and the reason they are there is because of that trend line and the reason that trend line is there is because of the Congress. And I think that it is very clear the challenge is ours and again, Mr. Chairman, it is not in this committee really, the appropriations have been controlled, it is those programs that have not been controlled and we know, all of us know, that is where the problem is.

Thank you, Mr. Chairman.

Chairman HATFIELD. Thank you, Senator.

Senator Eagleton?

## STATEMENT OF SENATOR EAGLETON

Senator EAGLETON. Thank you Mr. Chairman. I will be brief because I am anxious to hear from the witness.

I might add a minor footnote to what Senator Murkowski said. On the civil service retirement system, he made reference to the military system but I will put into the record an actual true example under the civil service retirement systems that illustrates what the Senator said. If a senior civil servant retired in 1972, 10 or 11 years ago and if the salary at the time he retired was $34,000, what would you guess, Senator McClure, the pension is that fellow received today?

Senator McClure. When did he retire?

Senator Eagleton. 1971 and his peak salary that year was $34,000.

Senator McClure. Exceeded.

Senator Eagleton. $52,000 is the pension today.

When retired he was making $34,000 a year and with all the double COLA's, et cetera, that person receives a pension of $52,000 a year. There is no pension system in the world that is anywhere like it. Take the biggest corporations in the world, take Japan—anywhere in the world no pension system that is comparable to that. And in the military retirement system the figures are the same because they were double COLA's throughout that same period.

I welcome Professor Weidenbaum. I call him that because he is from Washington University in St. Louis, my home city, and despite the fact that this recession is now called the "Weidenbaum recession"——

[Laughter.]

Senator Eagleton. We will welcome you back to St. Louis at the conclusion of your tenure. Thank you.

Chairman Hatfield. Senator Mattingly.

## STATEMENT OF SENATOR MATTINGLY

Senator Mattingly. Thank you Mr. Chairman, good to see you again Dr. Weidenbaum.

There is some ray of hope in a $100 billion deficit and I would think that this message has brought a ray of hope. I think the $100 billion deficit, if you want to talk about reality, has brought everybody to their senses in this Congress. I think it has gotten the attention of everybody now, and I feel like what is going to happen, we are going to see a lot of creativeness and a lot of thinking going on and I agree with Senator McClure and everything else that has been said here, now is the time it has to happen.

I know how it would look for somebody to say I like the $100 billion deficit, but I think it does focus on what needs to be done, and to my feiends who talk about the entitlements program, when we were talking about the entitlement program last year, I offered three opportunities for action. That we introduce bill S. 1666 and S. 1667 last year to move the COLA and also to adjust the cost of living index down to 85 percent, and also we put in legislation to cap annuities so this wouldn't happen.

I would say that I think now, those ideas that were laid down last year, were debated in the Senate, some in the House, and now I think we can offer a lot of creativeness, and the chance for all of us to get together and make something happen. Because the entitlement programs, until they are controlled, you will never balance the budget. That is a fact.

And the reality also is, to agree with Senator McClure, and he and I have discussed it as everybody else discusses it, that now is the time. I am not so sure whether we ought to be debating constantly in these hearing rooms with the television lights, I am sure we ought to be back somewhere working and making sure the ideas come out so we have an immediate impact upon the proposed budget. Get the ideas out front and passed immediately so there is a hope of the interest rates coming down so we can save the housing industry, so we can put more money in the savings and loans and all the other savings institutions.

I would say I am glad to see you here and as Senator Stennis said, we are chasing the rabbit. I don't think there is anyone else to blame. As Senator Garn said, we are the ones that are responsible and the rabbit is here, Senator Stennis said. Now is the time for us to be creative.

Thank you, Mr. Chairman.

Chairman HATFIELD. Thank You Senator Mattingly.

Senator Bumpers.

### STATEMENT OF SENATOR BUMPERS

Senator BUMPERS. First of all, I agree with both Senators Garn and McClure that no money is spent that Congress doesn't appropriate, and that is precisely the problem. It was Congress that voted for a $750 billion tax cut over the next 5 years and we are proceeding to spend $1.6 trillion on defense. In my opinion, those two things in themselves, if they were allowed to proceed at that pace, would assure an absolute economic disaster.

In my opinion, if the President remains intractable in saying that Congress can do whatever it wants as long as it doesn't touch the tax cut and defense budget, then what is a mess, is going to become a slap as well. I can tell you that I intend to do my part to undo much of the tax cut. I was 1 of 11 Senators who didn't accept that idea in the very beginning, it never made any sense to me, and it doesn't make any sense now. Frankly, I don't think it makes much sense to Dr. Weidenbaum or anybody else.

Congress is going to have to deal with these problems. I hope the President will cooperate, but if he doesn't and Congress is not willing to really confront the President, or even to override a veto, then we are going to have even more severe economic problems.

Thank you Mr. Chairman.

### STATEMENT OF SENATOR DeCONCINI

Chairman HATFIELD. Senator DeConcini.

Senator DECONCINI. Mr. Chairman, I find myself in a little different position, I voted for the tax cut, for the President's program with some reluctance I suppose, but also with some feeling that let's give it a try. Obviously what my party had proposed was not working. We had high interest rates, large deficits and I was hopeful that somebody, particularly the President and the members of his advisory group, knew something that I didn't know.

The projections were made of the $42 billion deficit for 1982 which played a major role give or take $10 billion as we do here, we still find ourselves out of control on the deficit side. So I do echo what Senator Bumpers mentioned that I hope the President and the administration is willing to work with Congress to find some alterations in program. I think it is so vital that we find some solutions, make some fine tuning or major tuning, whatever is necessary, don't consider it a political partisan issue one way or the other but try to find something that would lead this country to some stabilized deficit and some control over its monetary system.

And I only hope, Mr. Weidenbaum, that you can display that attitude when you meet with the President and his other advisers that I can't believe President Reagan is going to stand pat and not budge some place. We got to do something and I don't think we can wait until 1983 and I will consider any reasonable approach of alteration.

Thank you.

Chairman HATFIELD. Senator Byrd.

Senator BYRD. I am waiting to hear the witness.

Chairman HATFIELD. Senator Abdnor.

[No response.]

We welcome you Dr. Weidenbaum, and we would like to have you proceed. We have your written statement if you wish to summarize it or handle it as you wish.

## EXECUTIVE OFFICE OF THE PRESIDENT

## COUNCIL OF ECONOMIC ADVISERS

### STATEMENT OF HON. MURRAY L. WEIDENBAUM, CHAIRMAN

#### POSTMORTEM ON LAST YEAR'S BUDGET

Mr. WEIDENBAUM. I will read the highlights. I appreciate the opportunity to appear before you. I hope that my testimony will be helpful to you in your important deliberations.

I would like to briefly explain the economic assumptions that underly the budget.

If I may, I would also like to offer a postmortem on last year. As you recall, in February 1981 we issued forecasts, assumptions on economic growth, unemployment, and inflation. We said the CPI would increase 11.1 percent for the year. It actually increased 10.4 percent, we said that the unemployment rate would average 8.6 percent, it averaged 8.4 percent; we said that economic growth would be 1.1 percent, it was 2 percent. Not pinpoint accuracy but I suggest the first time at bat our economic forecasts were fairly close to the mark.

I thought I would mention that before turning to this year's set of economic assumptions.

Table 1 in my statement contains them and they of course serve two purposes: One, they are the basis for estimating the budget and, two, they give a picture of what we expect the economy to look like given enactment of the President's program.

#### CURRENT RECESSION ENDING

We are projecting that the current recession will be over by midyear and will be followed by sustained economic growth, of between 4 and 5 percent a year. I'm too modest to refer to that in the spirit of Senator Eagleton's point as the "Weidenbaum upturn." I think we can all take credit for the pending improvement in the economy. Simultaneously our assumptions suggest steadily reduced inflation—down to 6 percent next year and 4½ percent by 1987. An upbeat near-term outlook continues to be supported by a variety of recent data, and I should emphasize, by the great majority of private forecasters.

The leading indicators for December turned up, so did housing starts, home sales have increased in each of the last 3 months, new building permits were up substantially in January. All indicators of price trends show continued improvement. In addition, interest rates may have resumed their downward course. As you know the prime rate started coming down again yesterday. I suspect that real growth in the current quarter will show a smaller decline than the drop in the last quarter of 1981. Signs of the upturn will become increasingly visible in the late spring and early summer. I expect a modest but positive growth in the second quarter.

A combination of declining inflation, low interest rates and third quarter gains in personal income suggest a strong growth pattern for the second half of this year with output growing at an annual rate of over 5 percent.

In short, there has been no change in our outlook for 1982 since publication of the economic report.

For 1982 as a whole we estimate real GNP at about last year's level with unemployment averaging 8.9 percent. This implies some increase over January's 8½ percent. But the quarterly numbers will be showing a positive pattern as the year progresses.

## SECOND HALF 1982 RAPID GROWTH IN ECONOMY

The rapid growth in the economy in the second half of 1982 yields a rise in job holders, returning total employment to over 100 million. We are projecting a decline in the unemployment rate later this year with a fourth quarter level in the vicinity of 8.4 percent. Progress on inflation is encouraging and is likely to continue. The improvement in the CPI was 3 full percentage points in 1981 compared to 1980. Continuation of the policy of monetary restraint provides the basis for forecasting a further slowdown in inflation.

The changes in the forecast since last July mainly reflect the impact of the recession and the anticipated snapback from it.

A strong snapback from recession has been characteristic of the American economy. Indeed, near-term growth rates in our current estimates are well within the range of historical experience. The upturn, for example, through December 1985 shows an average annual growth of 4.8 percent.

Actually that is somewhat lower than the average growth for post-World War II recoveries which was 5.1 percent.

Quite clearly strong progress on inflation continues. I would like to speak about those budget deficits and how they will be financed.

## FINANCING OF BUDGET DEFICITS

To be blunt, the current deficit is much higher than I would like it to be. But given the recession, I believe a sensible approach is to plan carefully for reducing that deficit, as pointed out earlier, in the years that follow.

The relative size of the deficit, economically speaking, is far more important than the dollar magnitude. To the extent that deficits affect the economy and indeed in my judgment they surely do, the effects of a given deficit will be small in a large economy and larger in a small economy. From historical perspective in absolute size the projected deficits are substantial. Yet in any individual year they are not unprecedented when measured against the size of the economy or of the budget or of the pool of private saving available to finance those deficits.

Table 2 shows some historical perspective pointing out that in fiscal 1976 the deficit was 4 percent GNP and our estimate is for a peak of 3.2 percent in 1982.

And you get the same comparisons when you look at percentages of private savings. These are high numbers in terms of the role of the deficit, but if you look at the past several years, you find proportionately larger deficits in individual periods.

In my judgment it is extremely important to steadily reduce the deficit financing of the Federal Government in fiscal 1983 and beyond because that is the time we expect the private sector and its financing needs to be expanding significantly. During a recession, such as now, the deficit, although much larger than I would like to see, is not likely to prevent meeting the relatively modest funding needs of business and consumers. But in fiscal 1983 and beyond, substantial reductions in the deficit and in off-budget financing will be very much in order.

### ADMINISTRATION COMMITMENT TO REDUCING DEFICITS

The Reagan administration is strongly committed to reducing those deficits in the years ahead. For a variety of economic reasons, as well as considerations of practical policymaking, deficits are a cause for continuing concern.

In my statement I go through the detail of that.

The bottom line of our problem and yours is simple but not easily resolved. Government spending can never be costless. That is why the first order of business is to get spending under control. The second order of business is to determine, as we have done in the 1983 budget, the best combination of ways to finance that spending. All methods of paying the Government's bills impose real costs on the economy—whether it is raising funds by collecting taxes, issuing Government bonds or printing money.

### ADDITION OF REVENUES

We have made it clear to the Federal Reserve that we are not interested in revving up the printing press. Thus in addition to our targeted spending cuts our budget includes proposals to add $34 billion of revenues over the next 3 years. The remainder of the spending gap will have to be financed with Government securities that will be acquired by a wide variety of domestic and foreign institutions and individuals.

In short, we believe the administration's program represents the appropriate balance of spending, taxing, and borrowing during a difficult period of transition. And we look forward to working with the Congress in furthering our common objectives.

Chairman Hatfield. Thank you very much.

[The statement follows:]

## PREPARED STATEMENT OF MURRAY L. WEIDENBAUM, CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to appear before your Committee to discuss the economic assumptions used in the Federal Budget for the fiscal year 1983.

Before I move into some of the specific economic questions which have been raised, I would like to briefly explain the economic assumptions that underlie the fiscal year 1983 Budget. These economic assumptions serve a dual purpose. They are the technical basis for estimating revenues and expenditures in future years. The assumptions also provide a picture of the economy as we see it responding to the President's program (see Table 1).

Table 1

Economic Assumptions for the FY 1983 Budget

(Annual averages, calendar years)

| | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|
| Nominal GNP | 8.1% | 11.5% | 10.2% | 9.7% | 9.2% | 9.0% |
| Real Growth | 0.2 | 5.2 | 5.0 | 4.7 | 4.4 | 4.3 |
| GNP Deflator | 7.9 | 6.0 | 5.0 | 4.7 | 4.6 | 4.5 |
| CPI | 7.3 | 6.0 | 4.6 | 4.8 | 4.6 | 4.5 |
| Civilian Employment (millions) | 100.9 | 103.8 | 106.2 | 108.6 | 110.9 | 113.0 |
| Unemployment Rate | 8.9 | 7.9 | 7.1 | 6.4 | 5.8 | 5.3 |

As the assumptions suggest, we are projecting that the current recession will be over by mid-year and will be followed by sustained economic growth between 4 and 5 percent a year. Simultaneously, our assumptions suggest steadily reduced inflation, down to 4-1/2 percent by 1987.

An upbeat near-term outlook continues to be supported by a variety of recent data. The leading indicators for December turned up, as did housing starts. Home sales have increased in each of the last three months and new building permits were up substantially in January. All indicators of price trends suggest continued improvement in the months ahead. In addition, interest rates may have begun to resume their downward course.

Real growth in the current quarter should show a smaller decline than the 4.7 percent drop in the last quarter of 1981. I anticipate that signs of the upturn will become increasingly visible in the late spring and early summer. Thus, I expect a modest but positive growth rate in the second quarter.
The combination of declining inflation, lower interest rates, and projected third quarter gains in personal income suggest a strong growth pattern -- at an annual rate of over 5 percent -- for the second half of this year. In short, there has been no change in our outlook for 1982 since publication of the Economic Report.

For 1982 as a whole, we estimate real GNP at approximately last year's level, with unemployment averaging 8.9 percent. This, of course, implies some increase over January's weather-affected 8.5 percent. But as I have indicated, the quarterly numbers will be showing a positive pattern. Thus, the rapid growth in the economy projected for the second half of 1982 yields a rise in jobholders, returning total employment to over 100 million. And we are projecting a decline in the unemployment rate later this year with a fourth quarter level in the vicinity of 8.4 percent.

Progress on the inflation front is encouraging and is likely to continue. The CPI rose 10.4 percent in 1981, a better than three full percentage point improvement from the 13.5 percent increase in 1980. Continuation of the policy of monetary restraint provides the basis for forecasting a further slowdown in inflation to slightly over 7 percent this year. The less volatile GNP deflator, which rose 9.2 percent in 1981, is assumed to increase about 8 percent in 1982.

The changes in the forecast since last July mainly reflect the impact of the recession and the anticipated snapback from it. Thus, the current economic assumptions show much less growth in 1982 and a somewhat faster expansion in the years that follow than we previously indicated. A strong snapback from recession has been characteristic of the American economy in recent decades. Indeed, the near-term growth rates in these estimates are well within the range of historical experience. Specifically, the upturn envisioned here, through December 1985, reflects an average growth rate of 4.8 percent. This compares to the composite for all past World War II recoveries of 5.1 percent.

Progress on inflation in 1981 was greater than earlier expected and that positive experience has been incorporated in our estimates. The growth of nominal GNP (real growth plus inflation) is lower than previously assumed. This reflects the maintenance of a policy of monetary restraint which will be instrumental in gradually and steadily reducing inflation.

## Financing Those Deficits

I now would like to turn to the question of the budget deficits and how they will be financed. To be blunt, the current deficit is much higher than I would like it to be but, given the recession, I believe the sensible approach is to plan carefully for reducing the deficit in the years that follow.

The relative size of the deficits is far more important than the dollar magnitude. To the extent that deficits affect the economy, the effects of a given deficit will be relatively small in a large economy and large in a small economy. From an historical perspective, in absolute size the projected budget deficits for fiscal years 1982-1984 are quite substantial. Yet in any given year they are not unprecedented when measured against the size of the economy, or of the budget, or of the pool of private saving that will be available to finance these deficits.

For example, as shown in Table 2, in the 1975-76 time period, the relative size of the Federal deficit was larger than we are projecting. Specifically, the deficit was 4.0 percent of GNP in fiscal 1976 compared to our current estimate of 3.2 percent in fiscal 1982 and 2.7 percent for the budget now under review, fiscal 1983. Similarly, as a percentage of private saving, the deficit represented 22.5 percent of total private saving in fiscal 1976, compared to 19.1 percent this year and 14.9 percent in 1983. Also, the deficit as a percent of total budget outlays was 13.9 percent in fiscal 1975 and 18.2 percent in FY 1976. This is in contrast to the anticipated 13.6 percent in FY 1982 and 12.1 percent in FY 1983.

Table 2

The Deficit in Perspective

Budget Deficit

| Fiscal Year | Billions of $ | Percent of GNP | Percent of Private Saving | Percent of Budget Outlays |
|---|---|---|---|---|
| 1972 | -23.4 | 2.1 | 12.8 | 10.1 |
| 1973 | -14.8 | 1.2 | 7.2 | 6.0 |
| 1974 | -4.7 | .3 | 2.0 | 1.8 |
| 1975 | -45.2 | 3.1 | 17.8 | 13.9 |
| 1976 | -66.4 | 4.0 | 22.5 | 18.2 |
| 1977 | -44.9 | 2.4 | 14.5 | 11.2 |
| 1978 | -48.8 | 2.3 | 14.1 | 10.9 |
| 1979 | -27.7 | 1.2 | 7.1 | 5.6 |
| 1980 | -59.6 | 2.3 | 14.1 | 10.3 |
| 1981 | -57.9 | 2.0 | 12.5 | 8.8 |
| 1982 estimate | -98.6 | 3.2 | 19.1 | 13.6 |
| 1983 estimate | -91.5 | 2.7 | 14.9 | 12.1 |
| 1984 estimate | -82.9 | 2.2 | 11.6 | 10.3 |
| 1985 estimate | -71.9 | 1.7 | n.a. | 8.3 |

In my judgment it is important to steadily reduce the deficit financing of the Federal Government in fiscal year 1983 and beyond, when we expect the private sector -- and its financing requirements -- to be expanding significantly. During a time of recession, such as the present, the anticipated deficit, although much larger than I would like to see, is not likely to prevent meeting the relatively modest funding needs of business and consumers. But in fiscal 1983 and beyond, when we expect a period of rapid growth in the economy, substantial reductions in the budget deficit -- and in off-budget financing -- will be very much in order.

The Reagan Administration is strongly committed to reducing the deficits in the years ahead. For a variety of economic reasons, as well as considerations of practial policymaking, deficits are a cause for continuing concern. Financing budget deficits decreases the amount of private saving and foreign capital available to the private sector, and that reduces the economy's long-term growth prospects. The Federal Government raises the funds that it requires regardless of the level of interest rates. If saving flows are not adequate and interest rates rise, weak and marginal borrowers may be "rationed" out of the market.

Financing those deficits makes the Federal Reserve's job of monetary restraint more difficult. But we must not forget that in order for the inflationary potential of deficits to be realized, they must be monetized by the Federal Reserve. And I have every confidence that such a development simply is not in the cards. I believe that the Federal Reserve System is determined to maintain a policy of gradually reducing the growth in the supply of money.

The bottom line of our problem - and yours - is simple, but not easily solved. Government spending can never be costless. That is why the first order of business is to get spending under control. The second order of business is to determine, as the Administration has in its 1983 Budget, the best combination of ways to finance that spending. All methods of paying the government's bills impose real costs on the economy -- whether it is raising funds by collecting taxes, issuing government bonds, or printing money. We have made it clear to the Federal Reserve that we are not interested in revving up the printing presses. Thus, in addition to our targetted spending cuts our budget includes proposals that will result in added revenues of $34 billion over the next three years. The remainder of the spending gap will have to be financed with government securities that will be acquired by a wide variety of domestic and foreign institutions and individuals.

In short, we believe that the Administration's program represents the appropriate balance of spending, taxing, and borrowing during a difficult period of transition.

### EXPLANATION FOR RISE IN INTEREST RATES

Chairman HATFIELD. Mr. Chairman, Secretary Regan has publicly stated that interest rates do not parallel budget deficits, but rather follow inflation. With the falling inflation rates, how do you explain the rise of interest rates since December, and isn't this rise evidence that there is a relevance between deficits and interest rates?

Mr. WEIDENBAUM. Very frankly, Mr. Chairman, in our research of the economics literature we have been unable to find a direct relationship between interest rates and deficits.

What I do know, quite clearly, in recent months, as monetary growth shot up well above the Federal Reserve's own targets, at approximately that time, interest rates stopped declining, because they had been declining until recent months. But as monetary growth resumed at a very rapid rate, that precisely was the time that interest rates started turning up again and we have another example right now, we don't have to guess about it.

Right now the Federal Reserve has once again slowed down the growth of the money supply and as we all know, interest rates seemed 'to have resumed, they certainly have in the past week, their downward path.

The Treasury bill rates dropped over 2 full percentage points and banks are beginning as of yesterday to drop the prime rate again.

So I think the basic relationship is between monetary policy and interest rates.

Chairman HATFIELD. Then you would disagree with Chairman Volcker who says the money market is frightened because of the projected deficits and that if we reduce the Federal deficit $20 billion, this could have an effect of pushing interest rates down 2 to 3 percent.

Mr. WEIDENBAUM. I couldn't endorse his measure. But I will frankly say it is my evaluation that the smaller the deficit the better in terms of impact on financial markets.

Chairman HATFIELD. On what?

Mr. WEIDENBAUM. On financial markets and on interest rates.

I couldn't demonstrate a one-for-one relationship, but the smaller the deficit, the more funds will be available for private investment.

Chairman HATFIELD. So there is a relationship between deficits and interest rates in your opinion, regardless of literature?

Mr. WEIDENBAUM. In my opinion, yes. However, I think that the major impact on interest rates comes from inflation and monetary policy.

I think the variability of the money supply movement may also play a role.

### MONEY MARKET FEAR OF PROJECTED DEFICITS

Chairman HATFIELD. Do you consider the money market as frightened by the projected deficits?

Mr. WEIDENBAUM. I think they are concerned. In my discussions, and I, of course, do try to keep in touch with people in the financial community, they all share our concern about the high deficits, we need to bring them down. And very frankly, it is not the 1982 deficit that concerns them, as I speak to them, because they understand that we are in a temporary recession, they are concerned about fiscal 1983 and beyond and they want to see those deficits come down substantially.

Senator DECONCINI. Mr. Chairman, I am confused. I missed something if I can ask the Chairman to clarify.

Did I understand Mr. Weidenbaum you indicated in your statement that there was no relationship between interest rates and decifits?

Mr. WEIDENBAUM. No, sir, I didn't say that.

Chairman HATFIELD. He was deliniating between literature and today they have not found any in research.

Mr. WEIDENBAUM. I reported to the committee in response to the question the fact that the economic literature does not reveal a direct relationship between deficits and interest rates.

Chairman HATFIELD. You are not challenging that in terms of today?

Mr. WEIDENBAUM. I went on to point out that I think that deficits, even though I could't measure the precise effect, I think deficits do matter very much.

Chairman HATFIELD. Do you agree with Dr. Alan Greenspan, who more than a year ago indicated he did not think our Nation could function long at this kind of interest rate level?

Mr. WEIDENBAUM. I quite clearly think that a substantial decline in interest rates is the key to the strength and durability of the recovery but I think the recovery is in motion very frankly.

Chairman HATFIELD. Thank you.

Senator Proxmire?

Senator PROXMIRE. Mr. Weidenbaum, I wouldn't expect you to make any other assumptions. Obviously, if you did, you would be different than any Chairman of the Council of Economic Advisors that I have ever heard of and listened to for 24 years. But you are a cry in the wilderness. Take the people who are members of your party. Take

William Fellner, a member of President Ford's Council of Economic Advisers, take Herbert Stein, Chairman of the Nixon Council of Economic Advisors, take Rudy Penner, who was the Chief Budget Economist in the Ford administration, all these men, all these men say we are following the wrong path.

Fellner said the administration is projecting about a 10-percent increase in gross GNP for several years.

He went on to say: "We have never had a period of such increases that was not inflationary. Moreover, such large increases in nominal GNP are not consistent with the Federal Reserve policy of restraining growth of the money supply."

You are sitting there and telling us we can pursue a policy allowing us to sustain very large deficits and you are very optimistic about those deficits. Most people say the deficits are going to be bigger. You are indicating we can run those deficits and interest rates are somehow going to moderate when, except for the little blip you had yesterday, interest rates have been going up since the first week in December.

Mr. WEIDENBAUM. I always hesitate to correct the Senator from Wisconsin.

The record shows I was not too optimistic in the forecast for 1981, my first time at bat for this job but I was too cautious.

I underestimated the progress in bringing down inflation and I underestimated the economic growth.

### UNEMPLOYMENT

Senator PROXMIRE. How about unemployment?

Mr. WEIDENBAUM. That is right. I overestimated unemployment. That is the one I overestimated.

Let me point out in terms of the current prevailing economic opinion, when I say that I expect the second half of this year to show real growth in excess of 5 percent, I give you the February 10 edition of blue chip economic indicators.

This survey of the prevailing private forecasters cover every political view. What do they say about the first quarter of 1982, down 2.1 percent, I said it was down less than 1981 fourth quarter.

Second quarter up 2.4 percent. I said it was moderate, third quarter, 4 percent, fourth quarter up 5.1 percent.

I would say very frankly the administration forecast is representative of prevailing private forecasts.

They may turn out to be too optimistic or pessimistic but I think it is premature to come to a conclusion.

### BUDGET DEFICIT

Senator PROXMIRE. Let me try to point out what is really giving some of us a lot of trouble. The fiscal year 1981 Federal budget deficit was said to be $58 billion. If we count all the Federal credit programs that do not appear in the official budget, the deficit was not $58 billion but $142 billion.

Similarly, in fiscal 1982, the real budget deficit will not be $98 million but, when you include the Federal credit programs, $206 billion. That is a 45-percent increase.

Under all Federal programs in fiscal 1981, $142 billion was raised representing 35 percent of all the funds loaned in U.S. credit markets.

In 1970 or 1971, the Federal Government was absorbing about 17 percent of the total loaned in credit markets. Last year this share was 35 percent.

What impact will a 45-percent increase have on credit markets in fiscal year 1982 if we have the kind of recovery you are thinking about.

After all, the difficulty which Fellner, Stein, and Penner have is that they believe the Federal Governnent is going to crowd out private borrowing and that high interest rates are going to discourage the home building industry, the automobile industry, and small business generally. They cannot compete with the Federal Government. The Federal Governnent gets every nickel it wants to borrow while the private sector gives way when interest rates rise.

### FUTURE INCREASES IN FEDERAL BORROWING

What is your response to the fact that we are going to have a huge increase in Federal borrowing over the next year or two?

Mr. Weidenbaum. First of all, I hope you support our efforts to cut those off budget credit programs because such efforts are in the budget.

But certainly I point out that we anticipate as a result of that tax law the Congress passed, a rising share, not just absolute dollars, but a rising share of the economy in the form of private savings, the saving pool to generate the funds.

For example, it is our estimate that gross private savings this year will rise from about $479 billion last year to approximately $542 billion this year, to $651 billion in 1983, and $742 billion in 1984.

Senator Proxmire. You are pretty lonely. You don't agree with people like Kauffman and others who looked at the data for past years and couldn't find records that agree that——

Mr. Weidenbaum. I would rather not grade individual forecasters but I do recall their track record is somewhat shy of perfection also.

Chairman Hatfield. Senator Garn?

Senator Garn. Dr. Weidenbaum, getting back to my opening statement, would you agree as far as interest rates are concerned, it is those out-year deficits that are the most concern to those who make long-term loans?

Mr. Weidenbaum. Yes, sir.

### ELIMINATION OF FUTURE TAX CUTS

Senator Garn. Would you also agree that despite what many of the critics say, we should do away with the third year of the tax cut, cut it in half by next July to 10 percent, although I know in the papers, Walter Mondale said we ought to speed up that one toward the first of January this year which was rather surprising.

Isn't it true that the growth of the entitlements are so large that even if we were to decrease defense by $20 billion to $30 billion as some people advocate, take away the third year of the tax cut and cut it half for the next number that the budget would still not balance?

Mr. WEIDENBAUM. I believe that is correct.

Senator GARN. And therefore to get back to my original point, it is necessary that we have the courage to cut the growth, not cut the actual number but cut the growth of the entitlement program?

### ENTITLEMENT PROGRAM CUTS

Mr. WEIDENBAUM. Yes, sir, as I tried perhaps too subtlely in my statement to point out, the heart of the budget problem is the rapid growth rate of Government spending. That rapid growth is centered in the entitlements programs and therefore to be truly successful in getting these deficits under control, we have to focus there.

Senator GARN. My next question, focuses on the fact that neither Congress nor this administration has the courage that we propose that we really limit the growth of entitlements.

When is the administration also going to have the courage to talk about it? We will do what we can here.

Mr. WEIDENBAUM. There are specific proposals, as you know, in the fiscal 1983 budget for some changes in the entitlements program.

The President also set up a nonpartisan task force on the social security program which is the largest.

Senator GARN. But social security has been made an exception, that is 55 percent. I don't want to be quoted as cuttinq social security. I said slowing the increase in those growths but neither the administration or Congress has had the guts to talk about that and until we do, let's quit kidding ourselves about solving this long-term deficit problem.

We and this administration, both Republicans and Democrats in the Senate and the House, have got to come out from hiding and tell the American people what the problem really is and be willing to have some courage to slow that or we are playing the numbers game.

In 7 years in the Banking Committee, I have heard you, I have heard the world's best economists, liberal, conservatives, Republicans, and Democrats and for 7 years, everyone of them have been wrong.

Not once have they been consistent with each other. They have all been wrong.

### DOMENICI PLAN ON ENTITLEMENTS

Let me ask you one other question:

As you well know, in many of the meetings we have held that Senator Domenici, Senator McClure, and a few others have been very consistent for a year on the need of the entitlements, what is your response to the reported Domenici plan for the budget for 1983?

Mr. WEIDENBAUM. Senator Domenici's proposal is a good-faith effort to come up with a comprehensive plan. We want to take a closer look at it before offering detailed comment.

We do have some obvious concerns about the Domenici proposal. Some of those concerns relate to the specifics of how he would raise the revenues and the impact that would have upon economic recovery.

Some of the other concerns relate to the impact of his defense plan upon our national security.

Whether there would be any other adverse impacts of that proposed spending freeze is another item that obviously needs careful consideration before any evaluation is presented.

But I want to emphasize that I consider Senator Domenici's activity and his specific proposals a good-faith effort and one that deserves close consideration.

### ADMINISTRATION WILLINGNESS TO NEGOTIATE BUDGET

Senator GARN. So the administration is at least willing to consider negotiations, talk about further cuts, entitlements.

Mr. WEIDENBAUM. We have always said that we will consider a comprehensive alternative which respected the defense spending for the national security and the tax program; of course, the whole area of civilian spending should be focused on.

Senator GARN. I would close by saying I don't think there has been any more consistent defender of this administration and will continue to be so with this one exception of the unwillingness, along with Congress, I think share the blame, to face that entitlements growth be willing to face up to it, because I really sincerely, Murray, do not think we are ever going to solve this problem. The deficit will continue to grow unless we face that problem courageously and tell the American people where it is.

Mr. WEIDENBAUM. As you know, earlier last year, the President submitted a set of proposals dealing with social security.

The response to that, I think, very properly led the President to attempt an approach which was a nonpartisan approach. Why? Because it is important to develop a proposal that will get broad support in this extremely controversial area.

### RETIREMENT PROGRAM

Senator GARN. I understand but you heard from Senators from both sides of the aisle. Tom pointed out the problems in this retirement program. There is one thing to try to keep people at pace with inflation. It is something else to pay them more for not working than if they had stayed on the job.

I have a friend, retired brigadier general, making more now than he would if he stayed on active duty and were a major general. That is rather tough for those who are still working and Federal employees who never kept pace with inflation.

Mr. WEIDENBAUM. It is hard to defend that as a supply strategy.

Senator GARN. And most private pension funds have no escalators at all. The majority of the people in this country get none, they are stuck with whatever they get when they retired and they hurt.

So paying people more than when they were working is a problem we must address.

Thank you.

Chairman HATFIELD. Senator Stennis.

### EFFECT OF DEFENSE BUILDUP ON ECONOMY

Senator STENNIS. I am promilitary, I suppose, but I always advocated that the frugal expenditure of the military dollar and not throw it around just because it was that subject matter.

Now you say here in addition with some of your economic report that you have military spending expenditures at 9 percent annually between 1981 and 1987. I don't want to start to argue with that. As a result you say that defense buildup will add to pressure on the economy. And the report says that defense buildup could cause an increase in relative prices.

Do you mean to suggest there that it would be in the best interest of our overall economic security to slow this defense buildup down? That is going to be one of the major ways which I think the Congress is going to be looking for ways to avoid this $91.5 billion deficit which normally will end up running more than that. And the military figure is one of the things which contributes to the deficit.

What do you mean here about that 9 percent running things up?

Mr. WEIDENBAUM. First of all, in that section of the economic report we specifically state, Senator "Any economic effects, of defense spending, must be assessed in the context of the overriding need for maintaing the level of defense spending necessary for national security."

It has always been my view that the level of national defense spending should be set for security grounds and that the economy adjust to that. If you don't have an extra large defense spending because of a recession, you don't curtail defense spending because you are concerned about inflation, defense should be an overriding priority and that economic policy should adjust to it.

Consistent with that, my point here in the economic report is to do an economic analysis. That is my area of responsibility, and to point out that the rapid buildup in defense spending envisioned in the fiscal 1983 budget does impose a difficult task on the American economy, one which it can perform in my judgment. But I do point out, not only the effects but the need for minimizing those economic impacts. In this section of the economic report we emphasize such approaches as multiyear procurement and the need to carefully plan and develop the spending programs so that defense contractors have both the information and the incentive to engage in the development to expand their capacity so that they can meet the large needs to military procurement that we envision.

Senator STENNIS. I am pleased you commented on it and it would be valuable testimony to have. But it seems to me like you are claiming too much already about what the multiple year contract is going to do. Those things are highly speculative. I may favor some of this military reductions because I think we ought to try mighty hard to avoid this deficit.

## ENTITLEMENTS

Now I want to make clear, we got to hit the whole budget in the same way in order to do good primarily. I am definitely with those that say there is no way to get out of the present trouble and stay out of future trouble except to change this entitlement concept. It is just as clear to me as certain as night falls before daybreak and as I voted against some of those increases in entitlement benefits and after the entitlements were adopted I then voted for taxes to try to cover the benefits because it was already an obligation. That if we are to get down to the nitty-gritty something has got to be done to hold the line on entitlements.

Are you now planning any kind of approach to those entitlements, however small it may be?

Mr. WEIDENBAUM. Yes, sir.

Senator STENNIS. What about a reduction that would be across the board by some percentage point, could be very small as a starter. What are your plans now?

Mr. WEIDENBAUM. First of all, in the fiscal 1983 budget we present details of changes in the entitlements programs that would meet their objectives at somewhat lower cost. The main thing we have done, the President set up the task force on social security to develop proposals for dealing with the serious financing problem of social security which is the largest of those entitlements programs.

Senator STENNIS. You never needed any more than you will this year, some remedy along that line. That won't be available for consideration of the current budget, will it?

Mr. WEIDENBAUM. No, sir, it is scheduled for January 1983.

Chairman HATFIELD. Thank you, Senator Stennis. There is a rollcall in progress. We will continue the questioning and relay the gavel so that we will not interrupt this.

Senator Mattingly.

## RESTRUCTURING OF ENTITLEMENTS PROGRAM

Senator MATTINGLY. In reference to your economic literature.

Mr. WEIDENBAUM. I didn't write any of it, I was just reporting it.

Senator MATTINGLY. I assume that you believe in realities, right?

Mr. WEIDENBAUM. Yes, sir.

Senator MATTINGLY. Understanding that there are political decisions, there are people decisions in our country and hopefully we are putting aside political decisions and getting to the people decisions now, if this Senate, getting back to entitlements, proposes a change in the entitlement programs, a restructure of it, will the administration go along with it?

Mr. WEIDENBAUM. I can't say in advance. In general the approach we have taken is that we have developed for fiscal 1983 the programs that we think are the appropriate programs. We will consider alternatives that meet three requirements: One, that they are comprehensive, two, that they do not backtrack on the defense spending increases, and three, do not backtrack on the tax reduction.

Senator MATTINGLY. I agree with you wholeheartedly except in the area, we have never approached, quite get over the line in the dirt on entitlements and that is where it is, as the chairman spoke out in the beginning today, which everybody has spoken about on the entitlement program and until they reformed—and I don't think we can wait on a task force for social security or for some more task forces. They appointed another task force the other day on waste. There have been a sufficient number of reports by GAO and they can root out a little waste out of defense. What I am saying is——

Mr. WEIDENBAUM. Defense is the No. 1 assignment in the Department for that study.

Senator MATTINGLY. But the economic analysis that we are looking for is really reality and the reality is this uncontrollable part of the budget, which Chairman Hatfield spoke to which I probably refer to as the big E and that thing has to be taken on and it has to be taken on now.

There is no way that we can change the course of this country until we do and I think as far as relating to people, and I think you would agree that unless we reduce this budget more dramatically than it has been proposed, we are not going to create more jobs, we are not going to get the interest rates down, and we are not going to have the fundamental changes that need to be made.

I think in my opinion and I think in many peoples' opinion that the entitlements program although there are positive signs out there, that this will be the thing that will change the directions.

Mr. WEIDENBAUM. Senator, is the final outcome on this budget going to have the congressional imprint? Of course, we have made a first step on the entitlements. We would be willing of course to listen to suggestions for any second step.

Let me also emphasize that I think, and I say it is not just my judgment but that of some of my colleagues in the private sector, that this economy is in the early stages of a turnaround so that the second half of this year will be a strong period of economic growth and of declining inflation and of declining interest rates. I am not here to defend large budget deficits. The smaller the deficit the healthier the economy. But I think we can understand that the outlook given our program is very positive in terms of where the American economy is headed later this year.

### RETIREMENT PROGRAM

Senator MATTINGLY. Let me give you one other shot at reality, not to criticize all the programs, but as they talk about the retirement program here. I spent 20 years and 5 months with what I felt was one of the best companies of the United States, IBM, and I can spend one term in the U.S. Senate and my retirement is greater than that. That is what I refer to as the entitlements that are out of synchronization with the private sector. And I am saying, if you want to take an example, that is a prime example and this budget is shot through with those things and the entitlement programs are where it is.

I am sure that when the budget finally comes down somebody will end up taking $6, $8 billion out of defense, or a little bit over here or over there but the entitlements program is where the formidable changes are made and we can reconstruct and get the deficits down.

### EFFECT ON ENTITLEMENTS FROM SLOWDOWN OF INFLATION

Mr. WEIDENBAUM. Let me suggest, Senator Mattingly, that one of the most effective ways of slowing down in practice the growth of entitlement spending is to slow down the rate of inflation. It will take a while for that to effect all those complicated formulas but the substantial reduction in inflation underway is going to be a major reducer in terms of future entitlements.

Senator MATTINGLY. It is coming down too.

Mr. WEIDENBAUM. Yes, sir.

Senator MATTINGLY. But the fact that they used the index entitlements program is incorrect and everybody agrees.

Mr. WEIDENBAUM. Let me also suggest, having participated actively in the executive branch budget review, there are many opportunities for cutting departments and agency spending and the entitlements don't exhaust those opportunities.

Senator MATTINGLY. I agree. Thank you.

Chairman HATFIELD. We have 3 minutes to get to the floor to vote. Would you like to wait until after the vote? The committee will be in recess until return of the chairman.

Senator GARN. The committee will be in order. And I recognize the Senator from Arkansas.

### RETAINING TAX CUTS

Senator BUMPERS. Mr. Weidenbaum, is it your belief, as of this moment, that we can manage the budget deficits at some reasonable level; see lower interest rates; and have a growing economy if we leave the tax cut of last summer unchanged and, also proceed to spend at the rate the President has proposed in his fiscal 1983 budget?

Mr. WEIDENBAUM. Yes; I believe that is the case and those tax cuts will be very helpful in increasing the pool of saving to help Treasury financing. But I don't underestimate the huge presence of those deficits in financial markets, the uncomfortably huge deficits.

Senator BUMPERS. In addition to the saving you just mentioned, do you anticipate that savings are going to be sufficient to keep the anticipated deficits from adversely affecting interest rates, given the fact that they do affect interest rates?

Mr. WEIDENBAUM. Yes, sir.

Senator BUMPERS. The statistics I have seen show that both the IRA's and the all-savers are generating a lot of interest, but not very much new savings.

What kind of increase has there been in real savings due to the IRA's and all-savers certificates?

Mr. WEIDENBAUM. I have the total personal savings data and the change since October 1 is significant, that is for the first three quarters of 1981. The personal savings rate was 5 percent, for the October, November, December quarter, the personal savings rate was 6 percent. Quite clearly we are seeing an upturn, a measurable upturn not only in the dollar amounts but in their proportion of personal income that has been saved.

### IRA'S AND ALL-SAVERS CERTIFICATES

Senator BUMPERS. According to Business Week, a very small portion of any increase in personal savings is new money, which is what we must have if your theory is correct.

Mr. WEIDENBAUM. I believe, Senator, that the Business Week article refers to something else because the 5- and 6-percent figures, this is new savings, it is all new savings, no doubt about it.

Now in terms of the IRA's and the all-savers certificates, some of that is churning around, of course. I won't defend the all-savers certificates. I hope those things expire and Congress doesn't renew it. On the other hand I think the IRA does increase the long-term incentive for saving in this country.

Senator BUMPERS. In your statistics concerning real savings in this country are you including any corporate savings or retained earnings?

Mr. WEIDENBAUM. In the numbers I have given you, no, this is personal savings and these are not my numbers, these are Department of Commerce's official reports that I am using. And there is no doubt about the fourth quarter of 1981 which is the latest we have available, showed a measurable increase in personal savings over the three quarters before the tax cut.

### POSSIBLE ADVERSE EFFECTS OF DEFENSE BUILDUP

Senator BUMPERS. In your ecomomic report for 1982, on page 86, you discuss the possible adverse effects of the defense buildup. Here is what that report says:

> Although it is difficult to predict which industrial markets will be especially affected, three results of the defense buildup can be anticipated. First the substantial transfer of resources in the durabilities sector to defense productions may increase relative prices in at least some of the affected industries. Both the Department of Defense and the private purchasers may have to pay more for goods from these industries. Second, increased demand may produce delays in the delivery of military goods. Delivery timetables that seem realistic today, may, in some cases, become obsolete as producers try to accommodate the defense buildup and vigorous expansion in civilian development at the same time.
>
> A third effect may be some temporary crowding out private investment. Defense procurement and associated productions equipment use many of the same physical resources needed for private investment in civilian producer durability. Some private firms may turn to foreign sources for materials while others may cancel or postpone plans for expansion.

All three of those are bad, are they not?

Mr. WEIDENBAUM. Yes, I point out the key word in that entire section is "may." I didn't say "will" but I point out the possibility.

Senator BUMPERS. I can't believe that you allowed this to go into the economic report just because you think it is a possibility. I think you must feel it is probable and almost a certainty.

Mr. WEIDENBAUM. I didn't allow it, I wrote it.

Senator BUMPERS. That makes my question that much more compelling. You didn't dream those things up because you wanted to waive a little yellow flag. You wanted to waive a big red flag and say defense spending is inflationary.

Mr. WEIDENBAUM. Red is not my color.

Senator BUMPERS. Or anybody else in this administration.

Mr. WEIDENBAUM. I think as an economist it was my duty to analyze the one area of Government spending that is rising rapidly and to point out the possibilities.

Now, I pointed out these possibilities to the management of the Department of Defense and they have started with a variety of improvements in the procurement process, some of which I refer to in this report. And, very frankly, I did mean to encourage and support those improvements that the Department of Defense has under way.

### MONETARY POLICY

Senator BUMPERS. Turning to the question of monetary policy, in January the Commerce Department reported that plants in this country operated at 70 percent of capacity, one of the lowest industrial outputs in modern times.

In light of that, do you not believe that the money supply could be loosened, to some extent, without any inflationary impact given the fact that you could expand industrial production with 10 percent and that will still be very low?

Mr. WEIDENBAUM. No, sir, I think that the part of the inflation problem has been over the years too rapid growth in the money supply. And I think it is important that the money supply grow, and the public sees that we hope the Federal Reserve in 1982 operates, in the upper part of their target range. But certainly, we have seen in the last few months the serious cost of too rapid a growth in the money supply. Interest rates have shot up as I pointed out earlier. Those high interest rates are the most serious problem facing our economy. I think we have learned the hard way, and we say this in detail in chapter 3 of the economic report, there is no tradeoff with a stimulative policy. There is no Phillips curve. That kind of stimulative policy will get more inflation, but it is not, over a period of years, going to get more growth, more production, more jobs.

Senator BUMPERS. Would you favor a bill to have the term of the Chairman of the Federal Reserve Board coincide with that of the President so that we don't have this conflict between monetary policy and fiscal policy? This would really make the President accountable, would it not?

Mr. WEIDENBAUM. I had not studied that. It seems like a meritorious proposal but I would like to study it before giving a formal judgment. But I would describe it that way.

Senator BUMPERS. Thank you.

Chairman HATFIELD. Thank you, Senator Bumpers.

Senator McClure?

### GROWTH IN PERSONAL SAVINGS

Senator McClure. Thank you very much, Mr. Chairman.

You have referred to the growth in personal savings and as I recall your figures indicate a growth of 20 percent in the last quarter, up from 5 to 6 percent. What is the dollar amount involved?

Mr. Weidenbaum. It would take me a moment to dig that out. It is a substantial increase.

Senator McClure. I wonder if you could have one of your staff dig it out?

Mr. Weidenbaum. We have a very small staff.

Senator McClure. Very small, but good.

We are concerned about the reasons that interest rates have remained high—I think we would all admit that interest rates over a period of time must exceed the rate of inflation and unless the people making the investments are making bad judgments that will be some 3 to 6 or 7 percent above the rate of inflation.

Mr. Weidenbaum. It has been closer to 3 percent over the years but recently there has been frankly not just a 3 percent, or even 5 percent real interest rate, there also has been a volatility premium. A tremendous volatility in interest rates and the money supply over recent years, I think, has alerted investors to the great concern about the future of interest rates and hence there is a risk premium or a volatility premium.

Senator McClure. I was getting to that point because I am concerned that we see some very favorable signs over the last year masked by some very unfavorable reaction.

Do you have that dollar figure? I will stop for a moment.

Mr. Weidenbaum. First of all, let me point out that if that 1 percentage point increase in the saving rate extends the whole year, that implies an additional $20 billion in personal saving.

Senator McClure. Twenty billion dollars won't go a long way toward financing an additional $100 billion debt. It helps.

Mr. Weidenbaum. We are assuming it goes from 6 to 7 percent.

Senator McClure. Then we added another $40 billion, and you are still a long way away from $100 billion.

Mr. Weidenbaum. But the deficit is not increasing by $100 billion, in fact, if anything, the fiscal 1983 defict we are trying to get down——

Senator McClure. And certainly if interest rates come down, we get a very substantial impact upon the cost of financing the debt; is that correct? Getting interest rates down probably will do more for balancing the budget than will cuts in the defense spending. As an example, make a larger contribution.

Mr. Weidenbaum. Between the first and the fourth quarter of last year, total personal saving grew from $88.9 billion in the first quarter to $124.1 billion in the fourth quarter.

Increasing the pool of personal saving, as we forecast for the future, is a very realistic approach.

Senator McCLURE. I am still concerned that—the favorable signs are not matched by favorable performance in the economy.

We saw last year the interest rate drop by 20 percent. It is now 20 percent lower than it was at its high. That is favorable. We saw inflation rates drop by one-third to one-half depending upon what the latest figure may be. The gap between inflation—the rate of inflation and the prime rate of interest has grown, however, during that same period of time.

I was talking to a broker on Wall Street on Monday of this week and he said yes, inflation rates are going to come down. I said, "If you really believe that, are you investing in the long-term market? He said no.

I said, "Then you don't really believe that, do you?"

Would you come to the same conclusion he doesn't really believe it, or he would be looking into investment?

If he can get a tax exempt investment of 15 percent, doesn't that look like a pretty good investment to lock yourself into over a 30-year period if as a matter of fact you believe interest rates are going to fall?

Mr. WEIDENBAUM. Yes, the fact of the matter, since January 1982, short-term interest rates have come down substantially but long-term interest rates have only recently begun to decline.

Senator McCLURE. Yet if we really believe inflation is going to be under control, if we really believe interest rates are going to drop, then people ought to be moving into long-term markets.

Mr. WEIDENBAUM. In this job I don't provide investment advice.

Senator McCLURE. I understand that, and somebody else said if you are going to be in the business of making forecasts, you had better make them often. Maybe people forget the early ones you made. That is a part of the forecasting business, too, and I am subject to the same thing.

I have made some forecasts in the past and people read them back to me and show how wrong I was.

Mr. WEIDENBAUM. The second rule. If you ever make a good forecast, never let them forget, that is why I would like to cite the 1981 forcast.

Senator McCLURE. I understand that. But I am concerned about why it is that interest rates are not dropping when the rate of inflation has dropped as dramatically as it has?

Mr. WEIDENBAUM. I think the key is that volatility or risk premium which reflects the continuing large degree of uncertainy in financial markets.

Senator McCLURE. Does it also indicate that there is such a great return on short-term securities guaranteed by the Government that they don't have to take the risk in the long-term market?

Mr. WEIDENBAUM. I am not sure how much of a factor that is. I do think that to the extent that monetary and fiscal policy will demonstrably follow a steady course, that will reduce the uncertainty of the risk premium in those financial markets.

Chairman HATFIELD. Thank you.

Senator Eagleton?

Senator EAGLETON. Thank you, Mr. Chairman.

REVENUES

Dr. Weidenbaum, various Senators have approached through their questions various aspects of the economic dilemma in which we find ourselves. Senator Garn's questions in respect to entitlement was perspective, and Senator McClure's on interest rates as well. I want to focus on another fact.

I want to focus on the second part of your prepared testimony, namely, the revenue side.

As you concluded in your testimony, you pointed out that the administration is recommending $34 billion, and I will call it renew recapture, whatever phrase you want to put on it.

I prepared some sheets which I handed to your staff so they can glance at them before hitting you with them cold.

The deal with the sweeteners that were added to the 1980 tax bill—by way of background, the February 18, 1981, document called "America's New Beginning Program for Economic Recovery", which you have significant input in the formulation thereof, the President sent to Congress two basic tax proposals: 30 percent tax cut, 10, 10, and 10, accelerated depreciation. He said, "That is my economic proposal. Please get to work on it, Congress."

And you know what happened, and the blame is to be shared equally between the White House and the Ways and Means Committee, chaired by Mr. Rostenkowski. The unholy bidding war took place. Can you top this? In order to get the Kentucky delegation to vote through in something on thoroughbred race horses, in order to get Georgia people at least to think about something on pecan growing, in order to get this group to put in all the all-saver certificates—and you say you wish we had not started, and you certainly hope we end it when we end it.

Mr. WEIDENBAUM. Yes, sir.

Senator EAGLETON. So in this unholy bidding war, Reagan and Rostenkowski, each trying to top the other, a myriad of sweeteners, that is how they were called around here, they are added to the bill over and beyond the President's recommendation.

I will tick them off: marriage penalty; indexing; charitable contributions; foreign earned income; business tax cut provisions—including corporate rate cuts, small business cuts, R. & D. credit, rehab credit; royalty credit and exemption; reduced tax for new oil; other energy provisions; savings incentives provisions—IRA's, Keoghs, all-savers; estate and gift tax provisions, virtually eliminate estate and gift tax.

I've got an elderly father-in-law. He has made up his mind he is going to live that long for sure, so he and his heirs—I would hope the wife gets something—benefit by that one, and then another category we put on the sheet, miscellaneous.

The problem, when the bidding war was over, unfortunately you gave away the Federal Treasury. We gave away the Federal Treasury.

I submit to you, the President would be on solid ground, he would not be considering raffling, he went on national television and said; "Folks, I sent something up there on February 18, 1981, I would like to go back to that. I won't go back to the 10, 10, and 10 because we have already changed that 10 to 5, that is done, that is in place, but I would like to go back to my basic game plan and I would like to strip that garbage out.

"Unfortunately I got in a bidding war with Rostenkowski and the country suffered thereby." And as great a communicator as the President is, he is superb, the greatest in a prepared speech as opposed to a press conference.

[Laughter.]

Mr. WEIDENBAUM. He doesn't do badly.

Senator EAGLETON. He can make a speech and go back to his February 18 game plan and say humongus stuff, what do you think of it?

Mr. WEIDENBAUM. Very frankly, Senator, looking at the data in your chart, it strikes me that the term "sweetener" is not appropriate for the great majority of those added provisions. Why do I say that? The marriage penalty, indexing, the savings incentives, and the estate and gift provisions, they account for approximately $122 billion out of $144 billion and those were items we had stated would be seriously considered in a second tax bill.

What happened was an acceleration of the schedule, the first tax bill and the second tax bill were combined. I don't think reducing the marriage tax penalty is a raid on the Treasury, I think it is a necessary movement for some more equitable tax structure.

My wife doesn't work, so I'm not personally benefiting from that provision—she doesn't work for money. She holds down a volunteer job right now.

Indexing was an item in the President's platform, he ran on indexing, savings incentives, widespread, if not universal knowledge of the need for savings incentives in the tax code, and again we indicated estate gift tax changes were going to be seriously considered for the second tax bill.

Most of what happened, not all, I don't want to defend each and every one of those miscellaneous provisions but, $122 out of $144 billion were highly justifiable changes in the tax system. But I don't mean to defend each and every one of the smaller changes.

Senator EAGLETON. Doctor, I undersand that, but the truth is we couldn't have afforded that tax bill. The country cannot afford the revenue drain of that tax bill. I would like some of those things, too. I think the marriage penalty is rectifying that inequity. But the net bottom line is we cannot afford it. What about the Charlie Walker Saturday night. The President must recommend that dog. Why must you adopt that dog as part of your policy? Why does Occidental sell its tax laws, why does Burlington Northern, two of the most prosperous companies in the country? That is a raid on the Treasury.

Mr. WEIDENBAUM. We have, as economists, analyzed the effects of that entire ACRS in the economic report. I do think on balance we need, for long-term growth, provisions like that so that the companies, especially the ones in the Midwest and in the Northeast, who wouldn't otherwise benefit from the incentives for investment, to have a tax incentive for investment. But if the Senator does not think that the combination of an investment tax credit and ACRS meets this criteria, I suggest you consider an alternative.

Chairman HATFIELD. Thank you.

Now let me update the committee as to where we are. We have a vote on for a motion to instruct the Sergeant at Arms. Dr. Weidenbaum has to catch a plane at 11:30. We have Mr. Stockman to testify and he has to finish here by at least 12:15 or 12:30.

So I am going to suggest, unless there is just a burning question, that we permit the remaining members here one question each, in order to give everybody a chance to ask a question, but otherwise we go the normal 5 minutes.

Senator ABDNOR. I won't go 5 minutes.

### ECONOMIC ASSUMPTION ON INTEREST RATES

I may have missed it; what was your economic assumption for interest rates by the end of the year?

Mr. WEIDENBAUM. A significant decline. It isn't in my statement because that material is not in the economic report. It is in the budget document and that is the only interest rate we forecast in the budget: the interest rate on 91-day Treasury bills in 1982, 11.7 percent.

That is the average for the year—in 1983, 10.5 percent.

Senator ABDNOR. It has a long way to go before it gets down to the end of October.

Mr. WEIDENBAUM. Yes, but we made very substantial progress. As you know, in the past week the Treasury bill rate declined from 14½ on February 16 to 12¼ yesterday.

Senator ABDNOR. The interest did jump up shortly there for a period. My only point is this, I think in the particular area of interest rates, it is the No. 1 concern whether you are from a metropolitan area or South Dakota, like I am, where I travel a couple of thousand miles every recess.

The purpose of the big tax cut was to administer a stimulant. I am not so sure you are giving people confidence that interest rates are going to come down and deficits also, and I think confidence must be the word from the money lenders to the people who borrow. That is far more important at this time, I think, than some kind of a built-in artificial stimulant we try to create.

Don't you have some second thoughts?

Mr. WEIDENBAUM. My second thoughts are my first thoughts, those tax cuts are very much needed in the economy, but they need to be accompanied by very substantial spending cuts and there you have only seen the first installment.

The President has recommended in his new budget the second installment but we have a lot of work to do to control and cut the growth of Government spending to accompany those tax cuts.

Chairman HATFIELD. Could we give the other Senators one question? Senator Leahy?

INDEXING OF ENTITLEMENTS

Senator LEAHY. There have been a number of statements by you and others that the indexing of entitlements either be restricted or ended.

Is that basically a correct statement?

Mr. WEIDENBAUM. No, sir.

Senator LEAHY. You don't feel that indexing entitlements should be restricted or ended.

Mr. WEIDENBAUM. I think that is a subject that needs to be carefully considered,

The President established a task force on social security to deal with the entire financing problem affecting the social security system.

Senator LEAHY. What is your recommendation?

Mr. WEIDENBAUM. I am, like the President, waiting for our task force to report.

Senator LEAHY. What is your present feeling?

Mr. WEIDENBAUM. That is a high priority and as soon as the task force reports, we will do a detailed evaluation.

Senator LEAHY. What is high priority; to report or to decide whether we should continue the indexing?

Mr. WEIDENBAUM. How we deal with the problem. But for me to make up my mind and present a conclusion before the detailed study is more than begun, I think would be premature. It would show a closed mind.

Senator LEAHY. But you recognize it as a problem?

Mr. WEIDENBAUM. Yes.

Senator LEAHY. Is the indexing of the tax code, which we enacted last year, also a problem?

Mr. WEIDENBAUM. No; I think that is a real important advance. I think the Government should not profit from inflation as it has been.

Senator LEAHY. So the fact that indexing in 1985 it will cost $13 billion in 1986 in the area of $36 billion producing a total of approximately $49 billion, you don't see that as a problem?

Mr. WEIDENBAUM. I think that is a challenge to cut Government spending or the growth rate, rather, of Government spending in some similar proportion.

Chairman HATFIELD. Could I interrupt? We are in the last 3 minutes of vote.

We will submit questions, Dr. Weidenbaum.

Senator Sasser?

DEFENSE SPENDING

Senator SASSER. One quick question, Mr. Chairman.

The Council of Economic Advisers and I suppose you have been quoted as saying that defense spending over the next 6 years will have an "adverse economic effect."

Mr. Weidenbaum, what will be these adverse effects from the defense buildup which is coming now.

Mr. WEIDENBAUM. We said as we analyze the various possibilities there may be with the understanding here are impacts that may or may not occur and unless we alert the public to that—but that was not a forecast, that was just an indication of possibility. But all in all, we describe the program as quite manageable, given a maintenance of a policy of monetary restraint to reduce the overall inflationary pressure and continue to bring inflation down.

Chairman HATFIELD. I am going to turn the gavel over to Senator Specter, and after Senator Specter and Senator Sasser submit their questions, you are excused. Thank you for joining us today.

### BUDGET DEFICIT

Senator SPECTER. My one question concerns the $91 billion deficit. There have been a great many assumptions made, without ticking them all off. If those assumptions are incorrect and if you have last year's parameters, isn't it true that the deficit can be much larger, perhaps twice $91 billion.

Mr. WEIDENBAUM. Earlier this year I did a postmortem on our economic projections for last year, and it turns out in 1981, comparing the actual results with the February 1981 initial estimate, we were too cautious, the inflation actually was lower. Economic growth was higher than we said it would be. So much for our batting average in the past. But, yes, to the extent that the performance of the economy differs, up or down, from our estimates of the economy, the budget estimates will differ, up or down.

Senator SPECTER. Well, the committee is meeting your 11:30 deadline, Dr. Weidenbaum. I have ascended to the chairmanship of the Appropriations Committee by absentia. Having assumed this position, I am very reluctant to go to vote but the hearing is recessed until the real chairman has returned.

Mr. WEIDENBAUM. Thank you, Mr. Chairman.

### ADDITIONAL COMMITTEE QUESTIONS

Senator SPECTER. The questions Chairman Hatfield referred to earlier will be submitted for your response.

[The following questions were not asked at the hearing but were submitted to the Department for response subsequent to the hearing:]

## QUESTIONS SUBMITTED BY SENATOR MARK O. HATFIELD

Q. 1. Recovery from the Recession

Economist Alan Greenspan puts the odds at no significant recovery from the present recession at 1 in 3. What is your judgment on the prospects for no recovery, or a very modest one?

A. I fully expect a strong recovery from the current recession. As I noted in my formal testimony, we are projecting an economy expanding at roughly a 5 percent annual rate in the second half. This is in no way a disagreement with the forecast of my predecessor, as his most likely outcome -- with odds of two in three -- is also an economic rebound.

Q. 2. Deficits

Many Americans, professional economists as well as everyday citizens, are concerned about the crowding-out effect of the record federal budget deficits we face. Our European allies are equally concerned, on the grounds that this will sap capital from their economies. Paul Volcker says this is a serious problem, although not so much during a recession, when demand for money is down. What is the Administration's response to this concern about its record deficits?

A. First of all, let me reiterate that I do not like to see deficits of this magnitude. We project a reduction in the deficit in the upcoming fiscal years. However, it is important to stress that government spending can never be costless, no matter how we choose to finance it. We could finance the current level of spending with higher taxes, but their long-term detrimental effects on the incentives to work and productively invest was amply demonstrated during the 1970s. We could finance government spending, with the cooperation of the Federal Reserve, by money creation. But this sort of accommodative monetary policy led to the high levels of inflation which we have seen in the recent past. That is why we support the Federal Reserve's objective of a slower but steady rate of growth in the money supply.

The twin keys of proper fiscal policy are to have the government spend only on programs which are truly needed by society and then to select the least cost means of financing that spending. We have come a long way toward reducing the rate of growth of government spending. We would like to go further and I welcome the Congress' efforts along those lines.

Q. 3. Interest Rates

Chrysler Chairman Lee Iococca has argued that while there is plenty of money for the U.S. Treasury to borrow, and plenty for DuPont to buy Conoco and Sears to buy Dean Whitter, there is no money available for the purchase of autos and housing. As a result, these industries, which create jobs by additional sales, are in desperate condition. So he believes in credit allocation, and argues that the Federal Reserve should nudge the banking community to supply credit at more favorable rates to job-creating industries such as housing and autos. What is your response to this view?

Q. I believe that the private market is the most efficient mechanism we have for credit allocation, not more regulations. Our capital resources, though abundant, are a scarce economic resource which we cannot afford to waste. Allocating credit in Washington by political power rather than in the marketplace would be a serious mistake.

Q. 4a. Inflation

Are we on the road to ridding our economy of the abnormal inflation we have suffered in the past decade, or can the recent drop in inflation be attributed entirely to the economic slowdown and external factors such as the glut in the oil market?

To what extent have Administration policies brought about the reduction?

A. First of all, the current glut in the world oil market is in part a product of the economic policies of this Administration. The deregulation of the American oil market and the anti-inflationary policies we now have in place have both increased the competitiveness of the world oil market and reduced the speculative demand for oil as an inflation hedge. Clearly we have benefitted from the drop in oil prices, and we will also benefit as interest rates follow the inflation rate down.

To a large extent, inflation is a self-fulfilling prophesy. If people expect the rate of inflation to change, they will adjust the prices they charge accordingly. The recent developments in the markets for inflation hedges like gold and oil as well as the moderation in wage settlements we have recently seen all suggest that we have sharply altered inflationary expectations downward. I believe that the resolve shown by this Administration to stick to its policies of monetary restraint coupled with increased incentives to save and invest is largely responsible for this change in expectations.

Q. 4b. Inflation

The projection of the FY 1982 budget that declining inflation would be compatible with fast growth in real output went awry. The present budget makes no such projection, but still there is an expectation that recovery in 1982 and beyond will be accompanied by a steady downward trend in inflation, to below 5% eventually. On what basis do you expect this to happen?

A. The downward trend in inflation, as I have already mentioned, is likely to persist as the long-term expectations of people have changed. Long term, a slow but steady rate of growth in the money supply will provide the basis for a stable inflation environment with long-term growth. We are forecasting a rate of growth during the economic recovery in line with historical experience of other recoveries. In fact, our projection is slightly below the average postwar experience. The first years of most recoveries are accompanied by large budget deficits and stable inflation rates. I see nothing inconsistent, either from a policy standpoint or historical experience, to suggest that economic growth and low inflation are inconsistent.

Q. 5a. Tax Cuts

Herbert Stein, in an article in Fortune Magazine, made this statement: "Many Administration statements still reflect the notion that taxes are not only an evil but an unnecessary evil. This is a vestigial remnant of the theory, prominent during the campaign, that a reduction of tax rates would increase tax revenues, in addition to having a number of other good effects. Although hardly anyone believes this anymore, the taxophobia rationalized by this idea remains an element of Administration thinking." What is your reaction to this statement?

A. I would not share my predecessor's characterization of our policies as "taxophobia." However, we are firmly committed to reducing both the share of gross national product taken by taxes and the high marginal rates on saving and investment which discourage economic growth. It is true that an overall reduction in all tax rates will not yield higher revenues. Nonetheless, recent experience with the capital gains tax suggest that some taxes might produce more revenue when the rate is reduced. I do not think that this is true overall, however.

But, the main excess burden imposed by too high a tax rate is not the foregone revenue but the disincentive to overall economic activity. The economic literature is full of studies of the detrimental effect of taxes — particularly on saving and investment. A key part of restoring the economy to full economic health is a tax system which encourages, or at least discourages as little as possible, the supply of labor, capital, and entrepreneurial talent.

Q. 5b. Tax Cuts

Last year, at the oversight hearings on the FY 82 budget before this Committee, you offered the view that "the key element in the President's program is reduction in tax rates for individuals and an improved tax climate for capital formation." We have the first of these, but do we have the second? Or even the near prospect of the second?

A. The improvement in the tax climate for capital formation has been dramatic. The rate of return needed on new equipment to generate a constant real return has been halved. Effective tax rates on new business investment have been reduced dramatically without lowering the rate on capital which was already in place. The incentives for new capital formation are in place and they are dramatic.

Q. 5c. Tax Cuts

You have stressed the incentive effects of tax cuts, as generating savings, higher investments, improvements in productivity and reduction in inflation. Are not these strictly long-run effects? What if a slack economy and ongoing (if lower) inflation makes investment a less appealing option?

A. I do not anticipate a prolonged period of a slack economy. Quite the contrary, I foresee a period of robust growth. In part, this is because there is also a "demand-side" to those "supply-side" tax cuts. For the first time, we have a stimulative tax cut in place when we needed it. The old problem of fiscal policy being pro-cyclical, with Congress enacting a stimulatory tax cut after, and therefore on top of, a recovery which was already under way, is not the case this time.

Q. 5d. Tax Cuts

Why is it that many cash-rich firms are choosing to buy up other firms, rather than to undertake expansion of their own capacity? How much net new investment does this bring about?

A. The motivation for firms buying other firms is a complex issue involving factors including taxes and a reduction in the overall risk of the firm. Economists often describe this as the "market for corporate control." Like other markets, this buying and selling of firms provides an efficient way for scarce resources, in this case, managerial talent to be allocated. I do not think that it would be the proper province of the government to interfere in this market. I might add, however, that the Economic Recoverry Tax Act provides a disincentive to buy another firm rather than new equipment. The provisions of the Accelerated Cost Recovery System are only extended to new investment. Furthermore, a lot of mergers in the past have been motivated by tax considerations. The leasing provisions enacted last year reduce these considerations as an incentive for merger.

Q. 6a. Monetary Policy

We have been getting conflicting signals on the Administration's attitude toward the current monetary policy of the Federal Reserve. In January, you and the President were critical of the recent growth in the money supply. Now recently, the President praised the Fed. What is the Administration's attitude toward the Fed's policy? What do you believe that policy should be?

A. The Administration is committed to supporting a policy of expanding the money supply at a steady rate, although slower than the pace in recent years. It is one of the "four pillars," so to speak, of our economic program. We are completely behind the Fed's efforts to accomplish this objective. As to my own beliefs, I fully support the resolve of both the Administration and the Federal Reserve to bring the rate of growth of the money supply under control. As I look back during the past year, it seems clear that the statements of the Administration consistently supported the policies and targets of the Fed, although at times we noted the departures of monetary movements from those targets. At those occasions, our comments were consistently in terms of encouraging the Fed to operate within the targets that it itself had set.

Q. 6b. Monetary Policy

One Wall Street economist has stated that while the whole thrust of fiscal policy is expansive, monetary policy is anti-growth, and that this contradiction has resulted in the punishing level of interest rates and the present recession. Do you believe this is an accurate assessment?

A. No, I would disagree with that assessment. We have presented a balanced program of tax reductions and spending reductions. Even according to Keynesian analysis, the effect of a given amount of spending reductions is far larger than is the effect of a same amount of tax reductions. Thus, a deficit brought about by tax reductions could have a less stimulative effect than a deficit which was smaller but was caused by excessive government spending. I do not believe that the net stimulative effect of this budget is substantially greater than that of most Federal budgets, particularly given the phase of the business cycle during which it is occurring.

As to monetary policy, it is true that it has been restrictive, or to be precise, more restrictive than the recent past, but it is also important that we reduce the rate of growth of the money supply in order to contain inflation.

Q. 6c. Monetary Policy

How do you achieve consistency between budgetary policy and monetary policy? Are OMB's economic assumptions the same as those of the Fed? If there are differences, how do you take account of the possible differences in policy intent?

A. Although there is no formal arrangement, and this is only proper given the independent status of the Fed, we frequently consult with one another. I believe that we have a deep respect for the views of one another, and are in general quite closely agreed on the directions the nation should take. To the extent that there are policy differences, I suppose that the job of all of us here in Washington is to work out our differences as well as possible.

Q. 7. Unemployment

Would you expect that the recent phenomena of labor surrendering previously won wage concessions to spread to other depressed industries? Do you think this is healthy for the American economy? Does this indicate the possibility of a significantly reduced wage-price spiral in the years ahead?

A. In a market economy it is quite natural for prices to adjust based on market conditions. While I would not speculate on the cause of any particular change in prices or wages, it is important that prices be free to adjust in any market. The alternative to a price adjustment is a quantity adjustment, that is, if a price is too high and is held there, less of that resource will be used. A flexible wage and price environment makes the pains of adjustment to changing economic circumstances less severe.

Furthermore, I completely agree with your analysis that what we are seeing is a good sign of a reduction in the wage-price spiral in the years ahead. I believe that inflationary expectations have been significantly reduced, and I believe that this trend will continue.

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## QUESTIONS SUBMITTED BY SENATOR HARRISON SCHMITT

Q. 8a. Federal Credit Budget

The Federal credit budget for fiscal 1983 is $147 billion — roughly a 2.5 percent increase over Fiscal 1982. When added to the projected $91 billion deficit in the cash budget, Federal borrowing in fiscal 1983 appears to exceed $200 billion.

Is Government borrowing swamping the credit markets?

A. The Administration has made a major commitment to strengthen the credit budget and control the growth of Federal credit. I completely agree with your observation that we must take a broader look at all Federal credit activity when we analyze the government's impact on financial markets. Although I agree that total Federal borrowing is too large, I do not believe that "swamping" is an appropriate description. Federal credit activity has an effect beryond simple borrowing because it also redirects the pool of loanable funds to favored borrowers, and away from those with investments able to pay the costs of funds. This represents an efficiency cost on top of the increased cost of funds to all borrowers. That is precisely why we have been focusing increasing attention to the need to control all Federal credit programs, both on-budget and off-budget.

Q. 8b. Federal Credit Budget

What efforts are you making to control the Federal credit budget?

A. For fiscal 1983, the Administration's credit budget proposals bring direct loan obligations down by $7.4 billion from fiscal 1982. However, guaranteed loan commitments are budgeted to increase in 1983 by $11.3 billion, mainly due to an improved situation in the housing market. This represents a 2.7 percent growth of new direct loan obligations and new guaranteed loan commitments over 1982. However, due to increased repayments, the net change in Federal credit extended is estimated to decrease by 6 percent between 1982 and 1983.

Beyond the credit budget, is the need to bring Government sponsored agencies under better control. We prefer to modify the special relationship between these enterprises and the Federal Government in order to eventually transform them into completely private organizations. Fundamentally, a move toward market interest rates on Federal credit programs would represent a very constructive response to our mutual concern about the rapid rise in this type of Federal activity.

Q. 8c. Federal Credit Budget

Over the next five years, do you foresee a decline in the Federal Government's share of total borrowing, in order to alleviate upward pressure on interest rates?

A. Over the next five years, I foresee a decline in the Federal Government's share of both total borrowing, and its borrowing as a share of GNP. Although there is no direct relationship between the quantity of Federal borrowing and the interest rate, it is true that other things equal, the reduction in Federal borrowing as a share of GNP and private saving over the next few years, would tend to lower the real rate of interest.

Q. 8d. Federal Credit Budget

What do you think of the idea of offsetting any projected increase in the Federal cash budget deficit, over the $91 billion Administration estimate, with further reductions in the Federal credit budget?

A. I think that it may well be appropriate. We are prepared to accept any changes in the budget which are comprehensive and do not alter the basic commitment to rebuild our national defense or reduce the burden of taxes on individuals and firms. As I have already noted, borrowing in the Federal Credit program has an added cost in efficiency beyond the simple borrowing cost.

Q. 8e. Federal Credit Budget

If the Federal credit budget had to be cut another $20 to $30 billion, where would you suggest the cuts be made?

A. I support the Administration's budget as an appropriate choice. If the Congress were to suggest changes in the mix of programs that met the already stated I criteria, it would be a meritorious proposal. As I stated in my oral testimony, we would give serious consideration to a comprehensive set of proposals to deal with the deficit problem.

Q. 8f. Federal Credit Budget

A survey of small businesses indicates, despite recent layoffs, many firms plan to increase hiring during the First Quarter of 1982.

Since the vast majority of jobs are created by small businesses, wouldn't this seem to indicate the unemployment rate may soon begin to decline?

A. We would all like to see a decline in the rate of unemployment, and I believe that the evidence you suggest is a very positive sign. However, our projections suggest that the rate of unemployment probably will not decline for the next several months, and may well average at a higher rate for the year than it presently is at. I might add that last year we were too pessimistic about the unemployment picture, and the average rate of unemployment turned out to be somewhat lower than we projected. I hope that the same thing happens this year.

Q. 8g. Federal Credit Budget

When do you predict an end to the current recession?

A. I foresee an upturn in economic activity beginning around the middle of the year. The second quarter might turn out not to be one of growth, although I suspect that it will be. However, I fully expect a rapid expansion in the third quarter.

Q. 8h. In a recent article, Fortune Magazine proposed an alternative method of borrowing funds that could save $28 billion on Fiscal 1984 interest expenses. They propose to issue inflation-adjusted Treasury notes that pay a small real interest rate instead of the present high-fixed-rate securities.

What are your feelings about the feasibility of this proposal?

A. I believe that the idea is worthy of study, although I would not care to either endorse or oppose such an idea until further study of it has been done. Its chief meritorious feature is that it would lower to some extent the "risk premium" the market adds to current interest rates due to their past experience with changing inflation rates. Furthermore, because I expect a lower inflation rate in the years ahead, a lower total cost of borrowing could result.

## OFFICE OF MANAGEMENT AND BUDGET

## STATEMENT OF HON. DAVID A. STOCKMAN, DIRECTOR

### HIGHLIGHTS OF OVERALL BUDGET PICTURE

Chairman Hatfield. The hearing will resume. We welcome the Director of the Office of Managment and Budget, Mr. Stockman. You don't need any introduction to this committee, nor we to you. We are delighted to have you. If you will proceed to highlight your testimony at this time, we will then move to the questions and expedite the hearing as much as possible for your convenience.

Mr. Stockman. Thank you very much, Mr. Chairman. I am pleased to appear before your committee. I have a lengthy statement I would like to put in the record and then review four highlights of the overall budget picture in terms of the deficit and aggregates. I will focus for one moment on an issue that I know is of great concern to this committee—the question of discretionary versus entitlement programs and whether or not a disproportionate reduction or burden has been placed on the programs appropriated by this committee.

### FISCAL OVERVIEW

First, on the fiscal overview, I would like to remind this committee of one thing. I think we all understand it now, but it is an important starting point for our deliberations on the fiscal year 1983 budget—the sheer fact of life is that without a sweeping and comprehensive budget reduction plan or budget savings plan for 1983 and outyears, we face unprecedented, massive, and rising Federal deficits each year.

In my testimony, we have provided estimates at current service levels, which, of course, means no further policy actions from what is in the budget today for fiscal years 1983 through 1985, under a variety of economic assumptions both optimistic, pessimistic, and somewhere in between. Those calculations indicate the cost, they indicate the price, they indicate the detrimental impact if we fail to put together a plan this year to deal with these current services deficits. They range from $130 to $160 billion in 1983 rising the to $133 to $197 billion range in 1984 to $120 to beyond $200 billion in 1985 depending on which economic assumptions you use.

### A COMPREHENSIVE PLAN

The second point, Mr. Chairman, is that there is more to this budget that the administration has presented than simply the bottom line, although that has received most of the attention and most of the discussion. The deficits are important, but what lies behind them in terms of the comprehensive plan to reduce them is, in my judgment, is even more important.

This budget provides a comprehensive plan to reduce the deficits by 50 percent from these large numbers that I have just cited over the next 3 years. Deficits would be reduced by $56 billion in 1983 through a whole variety of measures on the revenue, entitlement, discretionary program, user fee, and management initiative side, rising to $84 billion by 1984 and nearly $100 billion by 1985.

Overall, what is most important about this budget is the $239 billion blueprint for reducing the deficit and insuring that as the recovery begins, the deficit is lowered. We are on a track of steadily moving it in a lower direction.

## IMPACT OF ECONOMIC CHANGES

The third point I would make, Mr. Chairman, is that these dramatic changes in the budgetary outlook in the magnitude of the deficits that we are dealing with both on a current service and after policy actions basis, result primarily from significant changes in the economic outlook both current and prospective. These have had major adverse impacts on the budget. The combined impact of much higher interest rates than we expected, a recession that we did not expect, and an inflation rate that is falling faster than anyone anticipated has been to increase the deficit in 1982 by $30 to $55 billion, depending on which forecast from last year that you start with, and by $40 to $90 billion in fiscal year 1983, the budget year before us, again depending on which forecast you start with last year.

The most significant factors in shifting the budget position and the deficit in this adverse way, in the change in the economic outlook that I have just cited, are the recession and the combined effect of the recession and a more rapidly than anticipated fall in the inflation rate.

These two factors together will reduce nominal GNP dramatically in 1982 and out years. It is nominal GNP that determines the level of governmental receipts, the taxes that we receive from businesses and households.

Compared to what we expected last year, nominal GNP would be $133 billion lower in 1983; $116 billion lower than what the CBO forecast just a year ago. By 1985 those differences are even larger—$291 billion lower than what CBO forecast last year, $242 billion, nearly a quarter of a trillion lower than what we forecast last year. This is a much lower prospective path of nominal GNP reflecting the recession, reflecting a more rapidly declining rate of inflation, and reflecting the fact that there will be a monetary lid on the overall expansion of the economy as the recovery begins. This means that budgetary receipts or revenues will be $30 billion lower in 1983 than CBO projected, $31 billion lower than we projected 1 year ago. By 1985, the change in the outlook for nominal GNP will mean revenues $71 billion lower than CBO projected and $60 billion lower than we projected.

That is the major change in the economic outlook. You can see it has a large and dramatic effect on the level of revenues in the sense of their reductions.

### DEBT SERVICE COST

The other major change is in the outlook for interest rates. As we all know, last year we experienced something unprecedented in the economic performance of the last decade or perhaps even the post-war period. Historically, the interest rate has tracked very closely to the inflation rate. Indeed, during the 1970's, the T-bill rate was actually lower than the inflation rate much of the time. This meant we were financing our Federal debt at a negative rate of return, a bargain for the Government.

That picture changed dramatically during 1981 as the financial markets caught up and as a premium above the interest rate of 4, 5, or 6 percentage points materialized. No one can adequately explain where or how long it will last. Some call it an uncertainty premium, some call it volatile premium, some call it a risk premium. Whatever the explanation, it is there and it is increasing dramatically the debt service cost of this Government both in the current budget year and prospectively.

We believe that as the inflation rate comes down the interest rate will come down gradually with it. As civility and credibility are restored, these unusual and unprecedented premiums will begin to diminish.

Nevertheless, under the forecast we are now using, interest-related outlays will be $31 billion higher in 1983 and $107 billion higher over the next 3 budget years.

So if you put this change on the down side on receipts, and on the up side on interest and debt service outlays, you have about 90 percent of the picture in terms of the change from the projections that we and others looked at last year relative to the enormous problem we are facing at the present time.

### DOMESTIC VERSUS DEFENSE SPENDING

The other point I want to make to the committee, Mr. Chairman, begins on page 60 of my testimony where I address an issue which has been raised with me numerous times by you and other members of this committee. The question is what is happening to discretionary or appropriated domestic programs and is the burden of reductions there disproportionate or extraordinary compared to the degree of fiscal restraint that we are attempting to impose in other areas of the budget.

Unfortunately, given the way that outlays are reported, as a net number, reflecting gross spending minus all of the receipts that come into the Government for a whole variety of purposes, offshore leasing, loan repayments and so forth, the numbers in the budget would make it appear that there has been a dramatically and Draconian reduction in 1 year in the appropriated program outlays or in discretionary spending generally. The reductions on a net outlay basis is $27 billion between 1982 and 1983, dropping from $131 billion in nondefense discretionary to $104 billion. This, on a calculated accounting basis, is a 21-percent drop.

But the actual fact of the matter is that offsetting receipts for all of these purposes and others that I have mentioned that come into the budget, as negative outlays will increase by $12 billion between 1982 and 1983. If we want to look at the impact of this budget and its recommendations on the activity level, on the program level, on the support level, we must strip out the offsetting receipts and look at gross outlays for a whole variety of domestic programs from manpower training to the Soil Conservation Service.

When we do that, there is a reduction. We make no effort to deny that. But it is a $15 billion reduction rather than $27 billion. It is 9 percent from the previous year, 1982, rather than a much larger percentage. We believe that reductions of this magnitude are appropriate in light of the severe fiscal crisis and circumstances that we face.

## GROWTH OF DOMESTIC SPENDING

I would point the committee's attention to the chart that we have provided on page 60 because I think it is important as you attempt to analyze the appropriateness, the justification, the rationale for reductions to look at more than a 1- or 2-year timeframe. You must look at a longer period of time to evaluate these changes and reductions in light of the previously existing trend.

In that table we demonstrate that for nondefense discretionary programs there was literally explosive growth throughout the entire decade of the 1970's. That set of programs cost $50 billion in 1970, by 1975 it was up to $86 billion, and by 1981, 5 years later, it was up to $164 billion.

These increases amount to 11.6 percent compounded rate of growth each and every year for domestic discretionary spending. Even when you strip out the inflation that occurred during those years, it amounts to a compounded annual growth rate of 3.3 percent, Government expansion of 3 percent after inflation each year.

By contrast, we provide in this table the figures for defense again to remind the committee that the decade of the 1970's looks much different than what we are facing today in terms of priorities and growth rates. You can see that the growth rate for defense during the 1970's was roughly one-half of the growth rate for domestic appropriated programs. In real terms, after inflation, defense spending actually declined at a 2 percent rate for that period of time.

What I am suggesting, Mr. Chairman, is that in the context of that rapid, unsustainable, and excessive growth rate that occurred and built up into total spending levels by 1981 over a decade, the retrenchment that we proposed in last year's budget and that we are suggesting with additional measures this year is well justified. Even when you recognize that there is an absolute reduction of $15 billion in outlays from 1982 to 1983, $160 to $145 billion in the domestic discretionary program, I think in no sense can these reductions be described as major retrenchments from past commitments.

The level of gross obligation for discretionary programs in the President's fiscal year 1983 budget is the same level as was provided in 1979 and, in real terms even after inflation is discounted, equals the level of 1976.

In all, the fiscal year 1983 proposed reductions pare back only 16 percent of this excessive growth in these programs over the last 12 years that I have just described.

### SPENDING ON ENTITLEMENTS

The second point here has to do with the relationship between these efforts to reduce the growth rate of Government spending and to pare back excessive commitments that were articulated in the past and the relationship of that with the trend in the entitlement programs.

On page 63 of my testimony I indicate that in the entitlement area, if you look at all other entitlement spending other than social security, you can see that again there was massive, rapid, and unsustainable growth in the decades of the 1970's from $40 billion in 1971 to nearly $152 billion in 1981. We have excluded social security from this on the grounds that the President's bipartisan commission is now considering that issue and will have recommendations this fall to the Congress. That amounted to a 14-percent annual compounded rate of growth. This growth is clearly something that could not be sustained without permanent massive deficits or setting increases in the tax burden on our private economy.

We have not made all the progress that we would like in reducing the growth rate of spending for these programs and reducing their entire fiscal impact. Nevertheless, with the measures adopted by Congress last year in the Reconciliation Act and the additional $23 billion in entitlement savings that we have proposed for this year and $52 billion over the next 3 years, we will have cut that growth rate from an excess of 14 percent to below 9 percent for the 1981–83 period.

On page 64 I try to put this in perspective in terms of the savings that we are proposing to achieve on the discretionary side versus those for nonsocial security entitlements. I think you can see from that comparison that there is some equality of burden between our fiscal restraint efforts in both areas of the budget.

I know this committee feels that in many areas the degree of cuts or holddowns that we have proposed simply are difficult to do given the program purposes and objectives being served. I would be very happy in our remaining time to respond to questions about the overall budget picture, the overall budget savings plan, or the details of any of the programs in the appropriated area.

I think in starting here, Mr. Chairman, it is important to point out that, in the aggregate, these trends appear not quite what they are sometimes suggested to be. If we can proceed from that common basis of facts and analysis, I believe that over the coming months we can work out funding levels for these programs that recognize our urgent fiscal crisis and at the same time meet the needs of which this committee is well aware.

That completes my statement, Mr. Chairman, and I would be very happy to take questions.

[The statement follows:]

## STATEMENT OF DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

### PERSPECTIVES ON THE PRESIDENT'S 1983 BUDGET PLAN

## I. OVERVIEW OF CURRENT FISCAL CONDITIONS AND ISSUES

- IN THE ABSENCE OF A COMPREHENSIVE BUDGET SAVINGS EFFORT, THE NATION FACES CONTINUOUS DEFICITS OF UNPRECEDENTED SIZE. ON A CURRENT SERVICES BASIS (NO POLICY ACTION) THE PROJECTED DEFICITS RANGE AS FOLLOWS, DEPENDING UPON WHETHER OPTIMISTIC, MODERATE OR PESSIMISTIC ECONOMIC ASSUMPTIONS ARE USED: (BILLIONS)

| FY 83 | FY 84 | FY 85 |
|---|---|---|
| $129 - 162 | $133 - 197 | $120 - 216 |

- THE PRESIDENT'S COMPREHENSIVE BUDGET SAVINGS PLAN IS DESIGNED TO REDUCE DRAMATICALLY THESE PROSPECTIVE DEFICITS AND ENSURE THAT THEY DECLINE STEADILY FROM THE FY 82 RECESSION PEAK.

| | 83 | 84 | 85 |
|---|---|---|---|
| ADMINISTRATION BUDGET SAVINGS PLAN.............. | -56 | -84 | -99 |
| REMAINING DEFICIT........... | 92 | 83 | 72 |

- THE REMAINING DEFICITS ARE DUE TO CHANGES IN THE ECONOMIC OUTLOOK SINCE LAST FEBRUARY, INCLUDING RECESSION, HIGHER INTEREST RATES AND A MORE RAPID THAN ANTICIPATED SLOW-DOWN OF INFLATION. ALL OF THESE FORCES OF ECONOMIC TRANSITION HAVE DRIVEN THE BUDGET TOWARD GREATER IMBALANCE -- AND WERE UNIFORMLY UNDERESTIMATED BY ALL BUDGET AND ECONOMIC FORECASTS OF ONE YEAR AGO. BUDGET PROJECTIONS BASED ON ECONOMIC FORECASTS ISSUED LAST YEAR BY THE REAGAN ADMINISTRATION, CBO, DRI AND THE CARTER - JANUARY BUDGET WOULD UNDERESTIMATE CURRENT DEFICITS BY THE FOLLOWING RANGES: (BILLIONS)

| 1982 | 1983 | 1984 |
|---|---|---|
| 31 - 57 | 40 - 89 | 29 - 91 |

- THE CURRENT SERVICES DEFICIT REQUIRING URGENT ACTION THIS YEAR IS OF ROUGHLY THE SAME MAGNITUDE WHETHER CALCULATED FROM THE ACTUAL ADMINISTRATION TAX AND BUDGET PROGRAM ENACTED BY CONGRESS LAST YEAR, OR FROM THE ALTERNATIVE FISCAL PROGRAM EMBODIED IN THE WAYS AND MEANS TAX BILL AND THE HBC FIRST BUDGET RESOLUTION. OUR PRESENT FISCAL PREDICAMENT IS A COMMON CONSEQUENCE OF CURRENT AND FUTURE ECONOMIC FORCES IMPACTING THE BUDGET -- NOT FISCAL POLICY OPTIONS CHOSEN OR REJECTED LAST YEAR.

| | 83 | 84 |
|---|---|---|
| CURRENT SERVICES DEFICIT WITH ADMINSTRATION PROGRAM AS ENACTED.......................... | -146 | -165 |
| CURRENT SERVICES DEFICIT WITH 1981 CONGRESSIONAL ALTERNATIVES*.................. | -150 | -149 |

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* ALTERNATIVE TAX POLICY BASED ON H.R. 4242 AS REPORTED FROM THE WAYS AND MEANS COMMITTEE ON JULY 24, 1981, AND ALTERNATIVE SPENDING POLICY BASED ON H. CON RES. 115 REPORTED FROM BUDGET COMMITTEE ON APRIL 16, 1981.

## II. CURRENT SERVICES DEFICIT ESTIMATE: DIMENSIONS OF THE FISCAL PROBLEM

- THE APPROPRIATE STARTING POINT IS THE RANGE OF BUDGETARY PROJECTIONS AT CURRENT SERVICES. THIS REPRESENTS WHAT WOULD HAPPEN IF WE SIT ON OUR HANDS, PERMIT THE BUDGET PROCESS TO POLARIZE OR PARALYZE, AND ALLOW THE BUDGET MOMENTUM TO RUN FORWARD ON AUTOMATIC PILOT.

- THE PROJECTIONS INDICATE SERIOUS DANGER TO THE ECONOMIC RECOVERY, STABILITY OF FINANCIAL MARKETS AND INTEREST RATES, AND THE ECONOMIC WELL BEING OF EVERY AMERICAN.

- THE FOLLOWING TABLE SHOWS A RANGE OF CURRENT SERVICES DEFICIT PATHS BASED ON THE ADMINISTRATION ECONOMIC FORECAST AND TWO ALTERNATIVE FORECASTS:

    - THE ADMINISTRATION FORECAST ASSUMES A RECOVERY BEGINNING IN THE SECOND HALF OF 1982, AN AVERAGE REAL GROWTH RATE OF 4.9% OVER 1983-85, WITH INFLATION FALLING TO 4.6%, UNEMPLOYMENT TO 6.4% AND THE T-BILL TO 8.5% BY 1985.

    - THE HIGHER GROWTH SCENARIO ASSUMES AN AVERAGE REAL GROWTH RATE OF 6.1% OVER THE 1983-85 RECOVERY PERIOD, WITH INFLATION FALLING TO 3.4%, UNEMPLOYMENT TO 4.5% AND THE T-BILL RATE TO 7.3% BY 1985.

    - THE LOWER GROWTH SCENARIO ASSUMES AN AVERAGE REAL GROWTH RATE OF 3.7% OVER THE RECOVERY PERIOD 1983-85, WITH INFLATION FALLING TO 5.8%, UNEMPLOYMENT TO 8.3% AND THE T-BILL RATE TO 9.7% BY 1985.

- THE DEFICIT THREAT TO FISCAL BALANCE AND ECONOMIC RECOVERY TRANSCENDS THE PLAUSIBLE RANGE OF ECONOMIC ASSUMPTIONS, AND CANNOT BE MITIGATED WITHOUT COMPREHENSIVE POLICY ACTION. SPECIFICALLY,

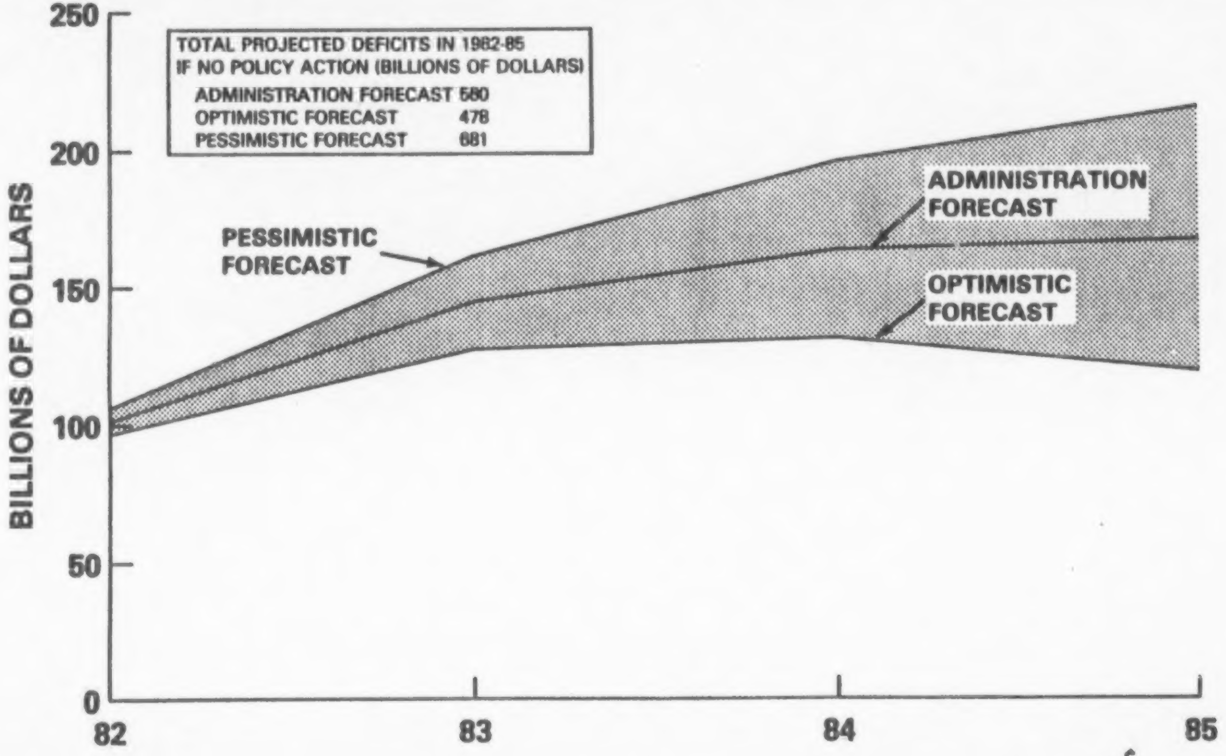
    - THE CURRENT SERVICES DEFICIT EXCEEDS $120 BILLION IN ALL CASES FOR THE FY 83-85 RECOVERY PERIOD;

    - THE SIZE OF THE DEFICIT STEADILY RISES FROM THE FY 82 RECESSION LEVEL;

    - THE CUMULATIVE ADDITION TO THE NATIONAL DEBT RANGES BETWEEN $478 AND $681 BILLION OVER FOUR YEARS.

# CURRENT SERVICES DEFICIT PROJECTIONS

(FISCAL YEARS)



## III. THE IMPACT OF ECONOMIC TRANSITION: RAPID DETERIORATION OF THE BUDGET OUTLOOK

- THE ECONOMIC OUTLOOK AS VIEWED BY PRACTICALLY ALL ANALYSTS EARLY LAST YEAR DID NOT ANTICIPATE MAJOR DEVELOPMENTS WHICH HAVE DRAMATICALLY ALTERED THE BUDGET PROJECTIONS FOR FY 82 - 85. THESE UNANTICIPATED DEVELOPMENTS INCLUDE:
  - THE PRESENT RECESSION;
  - THE RAPIDLY FALLING RATE OF INFLATION;
  - THE GREATER THAN EXPECTED TIGHTENING OF MONETARY POLICY IN MID-1981 AND THE PROSPECTS FOR SHARPLY REDUCED NOMINAL GNP LEVELS DURING THE RECOVERY PERIOD;
  - THE EMERGENCE OF UNPRECEDENTED PREMIUMS ABOVE THE INFLATION TREND IN NEARLY ALL INTEREST RATES, AND THE PROSPECT THAT THESE PREMIUMS WILL DIMINISH ONLY SLOWLY OVER TIME AS POLICY CREDIBILITY IS RE-ESTABLISHED.
- ALL OF THESE FACTORS REPRESENT ECONOMIC ADJUSTMENT FORCES OPERATING AS THE ECONOMY MOVES FROM A CONDITION OF EXCESSIVE MONEY AND CREDIT GROWTH, UNCONTROLLED FEDERAL SPENDING, RISING INFLATION AND STAGNATING REAL GROWTH TO LOW INFLATION, REVIVED REAL GROWTH AND MONETARY, FINANCIAL AND INTEREST RATE EQUILIBRIUM. ALL ECONOMIC FORECASTS USED LAST YEAR FOR BUDGET PROJECTIONS UNDERESTIMATED THE SEVERITY OF THESE ECONOMIC ADJUSTMENTS AND THEIR ADVERSE CONSEQUENCES FOR THE BUDGETARY OUTLOOOK.
- THE FOLLOWING TABLE COMPARES THE CURRENT ADMINISTRATION DEFICIT PROJECTION -- INCLUDING ALL PROPOSED BUDGET SAVINGS MEASURES -- WITH RE-ESTIMATES OF THE CURRENT BUDGET BASED ON EARLY 1981 ECONOMIC ASSUMPTIONS FROM A VARIETY OF SOURCES. IN EVERY CASE THE DEFICIT PROJECTIONS ARE DRAMATICALLY LOWER BECAUSE THE ECONOMIC ADJUSTMENT FORCES DESCRIBED ABOVE WERE NOT ANTICIPATED. ON AN AVERAGE BASIS, THE CHANGED ECONOMIC OUTLOOK HAS INCREASED THE PROJECTED DEFICIT BY:

--- $42 BILLION IN FY 82

--- $59 BILLION IN FY 83

--- EQUAL OR LARGER AMOUNTS IN THE OUT-YEARS

## CURRENT ADMINISTRATION BUDGET RE-ESTIMATED WITH EARLY 1981 ECONOMIC FORECASTS

| | 82 | 83 | 84 | 85 |
|---|---|---|---|---|
| 1) CURRENT ADMINISTRATION DEFICIT ESTIMATE............................ | -99 | -92 | -83 | -72 |
| 2) CURRENT ADMINISTRATION BUDGET RE-ESTIMATED WITH EARLY 1981 ECONOMIC ASSUMPTIONS: | | | | |
| CARTER - JANUARY................. | -54 | -32 | -24 | -11 |
| ADMINISTRATION - FEBRUARY......... | -42 | -2 | +8 | +21 |
| DRI - FEBRUARY.................... | -63 | -46 | -47 | -23 |
| CBO - MARCH....................... | -68 | -52 | -54 | -51 |
| AVERAGE DEFICIT, EARLY 1981 FORECASTS......................... | -57 | -33 | -29 | -16 |

A) THE TIMING AND SEVERITY OF THE RECESSION WAS NOT ANTICIPATED

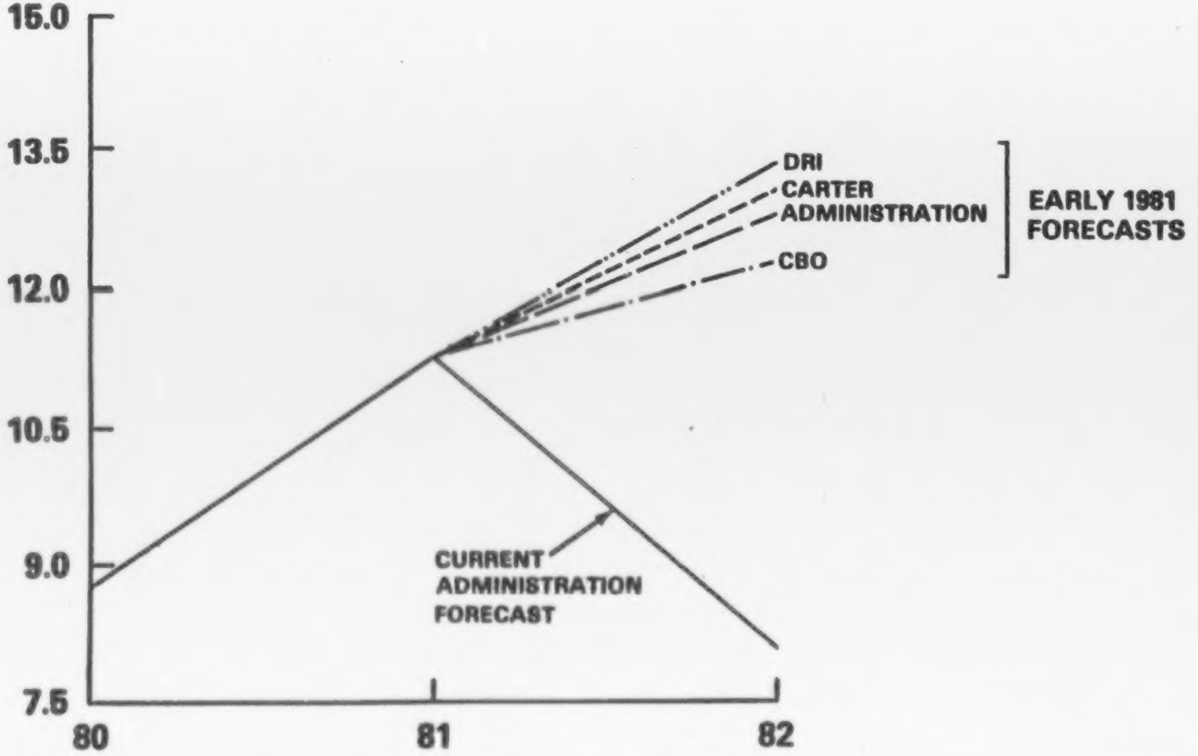
- o ALL MAJOR FORECASTS ASSUMED THAT AFTER A FEW SLUGGISH QUARTERS IN 1981, ECONOMIC EXPANSION WOULD RESUME STRONGLY IN THE FALL AND INTO 1982. AS A CONSEQUENCE, THE 1982 GNP GROWTH RATE WAS OVER-ESTIMATED BY 50 - 65 PERCENT. WHEN COMBINED WITH HIGHER UNEMPLOYMENT, FY 82 BUDGET RECEIPTS AND UNEMPLOYMENT RELATED OUTLAY ESTIMATES WERE OFF BY LARGE MAGNITUDES.

- o MOREOVER, THE LOWER BASE OF 1982 GNP AND THE RECESSION DRIVEN INCREASE IN THE FY 82 DEFICIT BOTH CARRY-OVER INTO FUTURE BUDGETS, WORSENING THE DEFICIT OUTLOOK:

| | FY 1982 | |
|---|---|---|
| | RECEIPT OVER-ESTIMATE (IN BILLIONS) | UNEMPLOYMENT RELATED OUTLAY UNDER-ESTIMATE |
| CARTER - JANUARY.................... | $38 | $7 |
| ADMINISTRATION - FEBRUARY........... | 31 | 8 |
| DRI................................. | 35 | 8 |
| CBO - MARCH......................... | 30 | 6 |

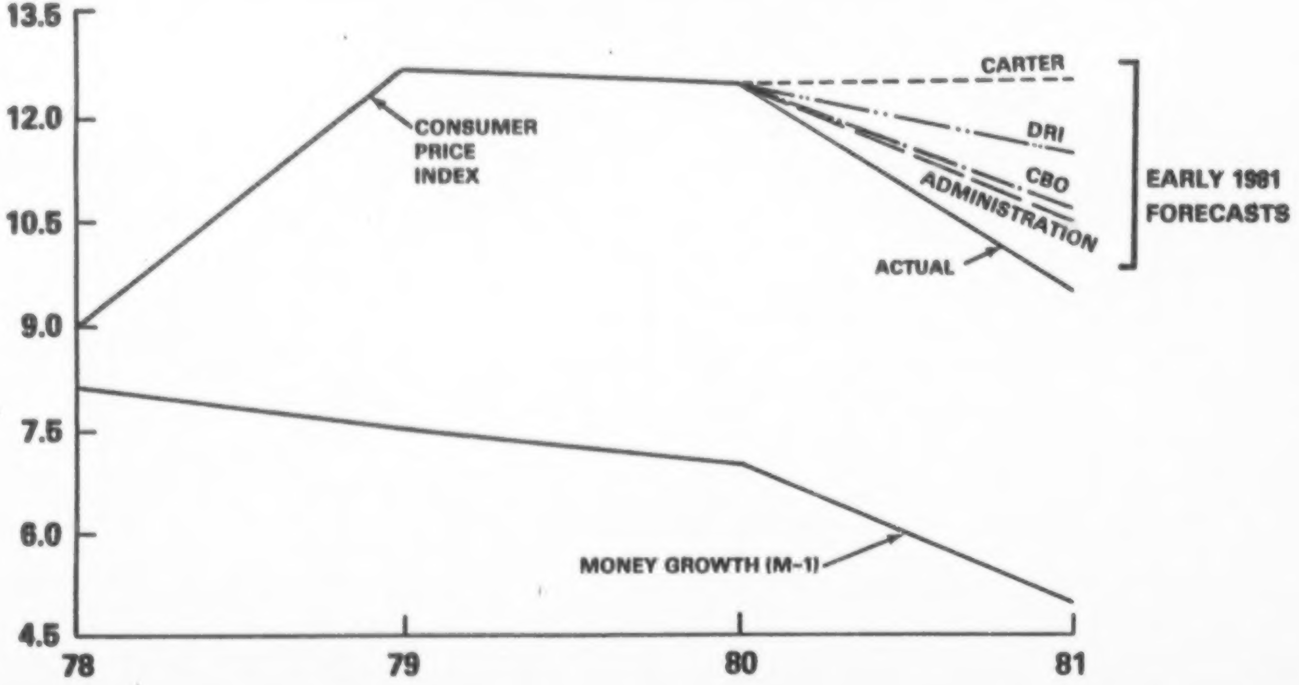
# GNP GROWTH FORECAST COMPARISON

(PERCENT CHANGE, YEAR OVER YEAR)



## GREATER THAN EXPECTED 1981 DECLINE IN MONEY GROWTH AND INFLATION

(PERCENT CHANGE, 4TH Q OVER 4TH Q)



## B) THE MONETARY LID ON NOMINAL GNP AND RECEIPT GROWTH: THE BUDGETARY IMPACT OF RECOVERY WITHOUT RE-IGNITING INFLATION.

- 1981 MARKED A FUNDAMENTAL DEPARTURE IN THE PREVIOUSLY UPWARD MOVEMENT OF MONEY, PRICES AND THE INFLATIONARY SPIRAL. GROWTH RATES TURNED ABRUPTLY DOWNWARD -- SUBSTANTIALLY MORE RAPIDLY THAN ANTICIPATED IN MOST FORECASTS EARLY LAST YEAR.

- ON A FOURTH-OVER-FOURTH QUARTER BASIS, THE MONEY SUPPLY GROWTH RATE DECLINED BY 30 PERCENT, THE CPI BY 25 PERCENT, AND THE PPI BY 42 PERCENT.

- THE DISINFLATION PROCESS IS CLEARLY UNDERWAY -- BUT THIS WELCOME IMPROVEMENT FOR THE ECONOMY IS A SERIOUS CHALLENGE TO BUDGETARY EQUILIBRIUM DURING THE TRANSITION.

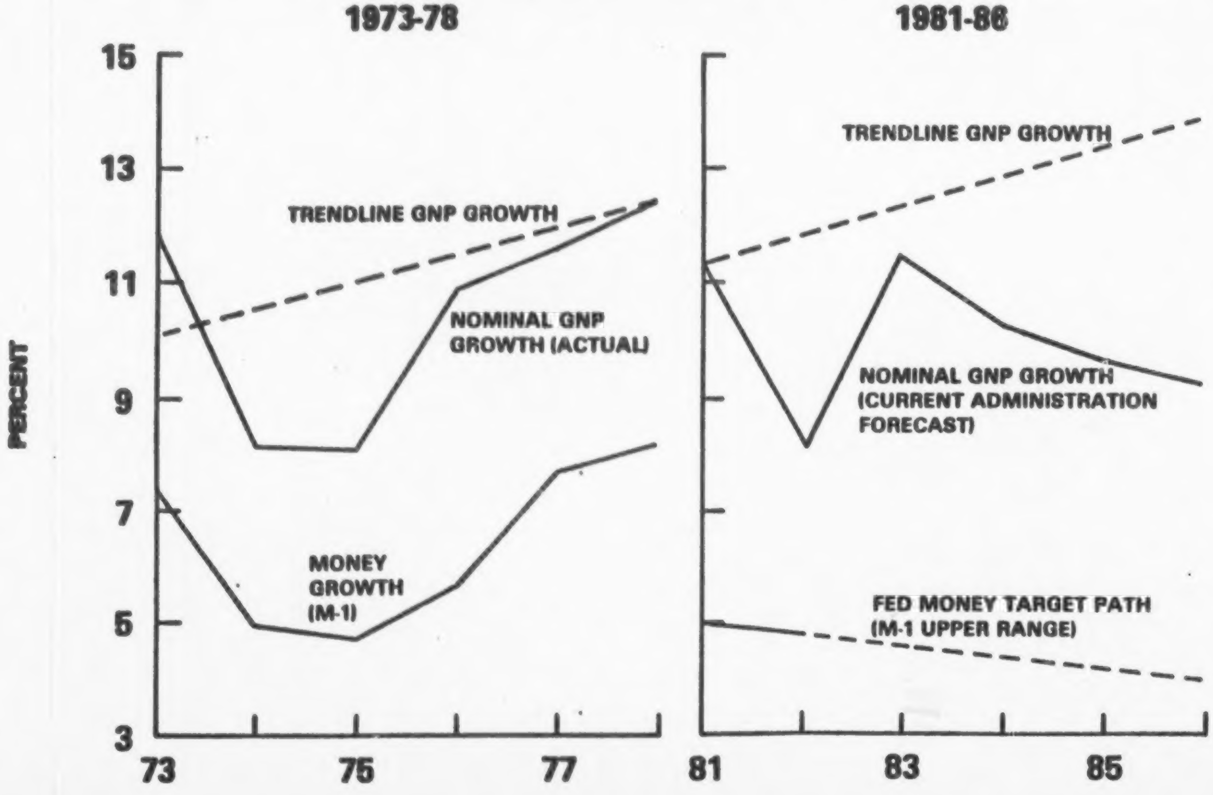
- THIS DRAMATIC PROGRESS IN SLOWING THE GROWTH OF MONEY AND INFLATION MUST BE PRESERVED -- BECAUSE PERMANENT ECONOMIC RECOVERY IS NOT POSSIBLE WITHOUT CONTINUED REDUCTION OF INFLATION. HOWEVER, PRESERVING THESE GAINS ON THE INFLATION FRONT WILL HAVE A PROFOUND IMPACT ON THE COURSE OF THE ECONOMY AND THE BUDGET OVER THE NEXT SEVERAL YEARS OF ECONOMIC RECOVERY AND BUDGET TRANSITION.

- UNLIKE THE PATTERN OF PREVIOUS RECOVERY PERIODS, MONEY SUPPLY GROWTH MUST BE HELD IN CHECK TO AVOID RE-IGNITING INFLATIONARY EXPECTATIONS AND UPWARD PRESSURE ON PRICES. THIS MEANS THAT THERE WILL BE A MONETARY LID ON THE GROWTH RATE OF NOMINAL GNP AND RECEIPTS DURING THE RECOVERY PERIOD.

- BY CONTRAST, DURING THE 1975-78 RECOVERY/RECESSION CYCLE, MONEY SUPPLY GROWTH STEADILY ACCELERATED IN EACH RECOVERY YEAR, RISING FROM 5.0% IN 1975, TO 6.2% IN 1976, TO 8.2% BY 1977. THIS PERMITTED AN EQUALLY RAPID RECOVERY OF NOMINAL GNP GROWTH FROM 8% IN 1975 TO 12.4% BY 1978. THE CONSEQUENCE WAS RISING PRICES AND RAPID INFLATION-FUELED GROWTH OF BUDGETARY RECEIPTS.

- DURING 1982-85, JUST THE OPPOSITE PATTERN WILL OCCUR IF ANTI-INFLATION MONETARY POLICY REMAINS ON TRACK. AFTER THE ANTICIPATED RECOVERY OF NOMINAL GNP IN 1983, THE NOMINAL GNP GROWTH RATE WILL STEADILY FALL -- RATHER THAN RISE -- AS INFLATION IS SQUEEZED OUT OF THE ECONOMY AND THE LID ON MONEY GROWTH IS MAINTAINED. THIS LID ON MONEY GROWTH, INFLATION AND NOMINAL GNP MEANS THERE WILL BE NO INFLATION-FUELED GROWTH OF BUDGET RECEIPTS AS HAS OCCURRED DURING RECENT BUSINESS CYCLES.

# IMPACT OF MONETARY LID ON GNP GROWTH



- THIS ANTI-INFLATION LID ON MONEY GROWTH, NOMINAL GNP AND BUDGET RECEIPTS WAS NOT ACCURATELY REFLECTED IN ANY OF THE EARLY 1981 FORECASTS, INCLUDING THAT OF THE ADMINISTRATION. IN COMBINATION WITH THE FAILURE TO PREDICT THE MUCH LOWER 1982 RECESSION GNP LEVEL, THIS MEANS THAT 1983-85 NOMINAL GNP LEVELS AND BUDGETARY RECEIPTS WERE DRASTICALLY OVER-ESTIMATED BY ALL FORECASTS.

MAGNITUDE OF GNP AND RECEIPT OVER-ESTIMATE

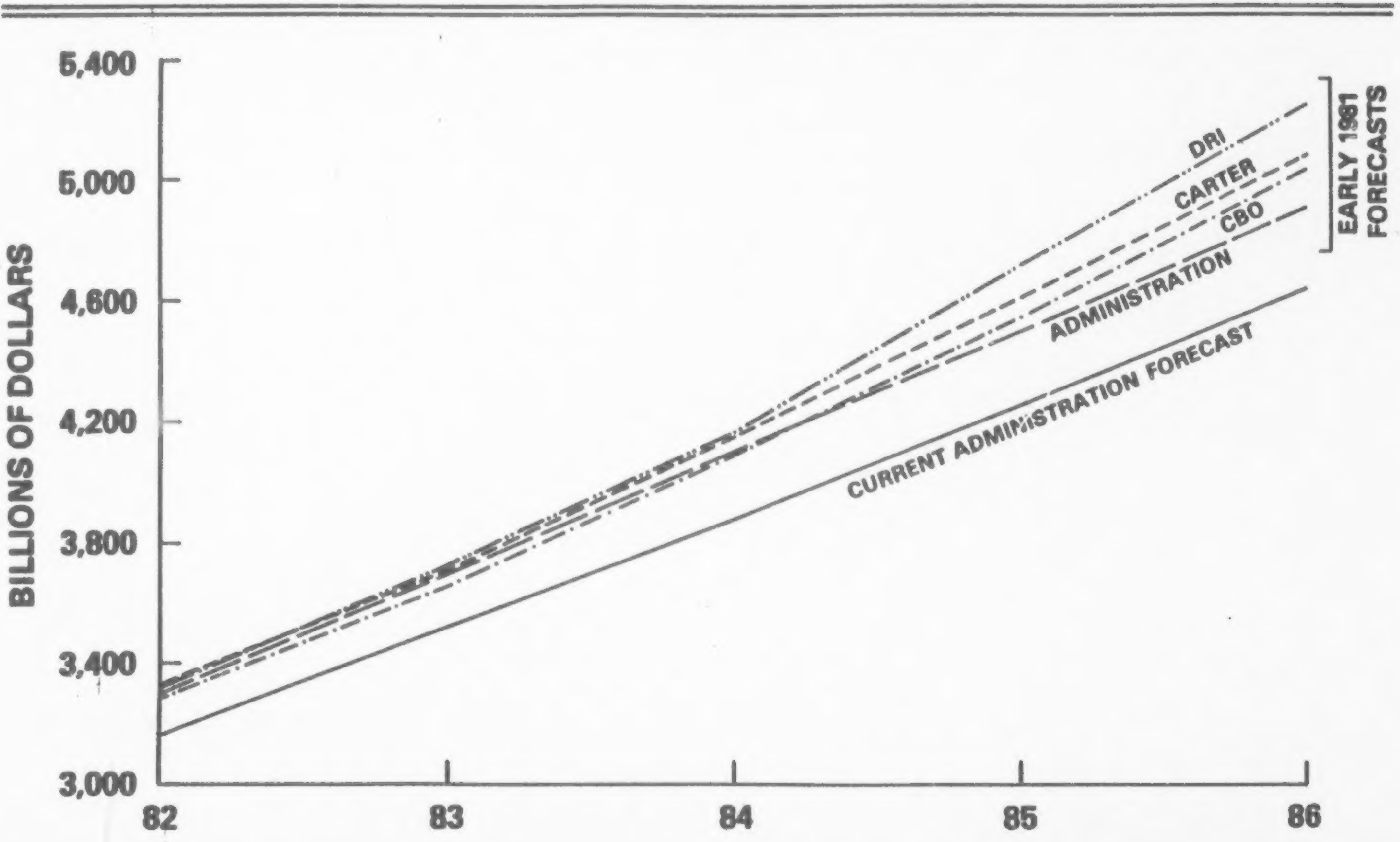
| | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| I. EARLY 1981 OVER-ESTIMATE OF GNP RELATIVE TO CURRENT ADMINISTRATION FORECAST (BILLIONS) | | | | |
| CARTER - JANUARY.............. | $152 | $194 | $273 | $353 |
| CBO - MARCH................... | 116 | 139 | 208 | 291 |
| ADMINISTRATION - FEBRUARY..... | 133 | 176 | 215 | 242 |
| DRI - FEBRUARY................ | 150 | 198 | 286 | 467 |
| II. EARLY 1981 OVER-ESTIMATE OF RECEIPTS RELATIVE TO CURRENT ADMINISTRATION FORECAST (BILLIONS) | | | | |
| CARTER - JANUARY.............. | $38 | $57 | $69 | $84 |
| CBO - MARCH................... | 30 | 51 | 54 | 71 |
| ADMINISTRATION - FEBRUARY..... | 31 | 53 | 57 | 60 |
| DRI - FEBRUARY................ | 35 | 60 | 69 | 106 |

C) INTEREST PREMIUMS AND FINANCIAL MARKET TRANSITION

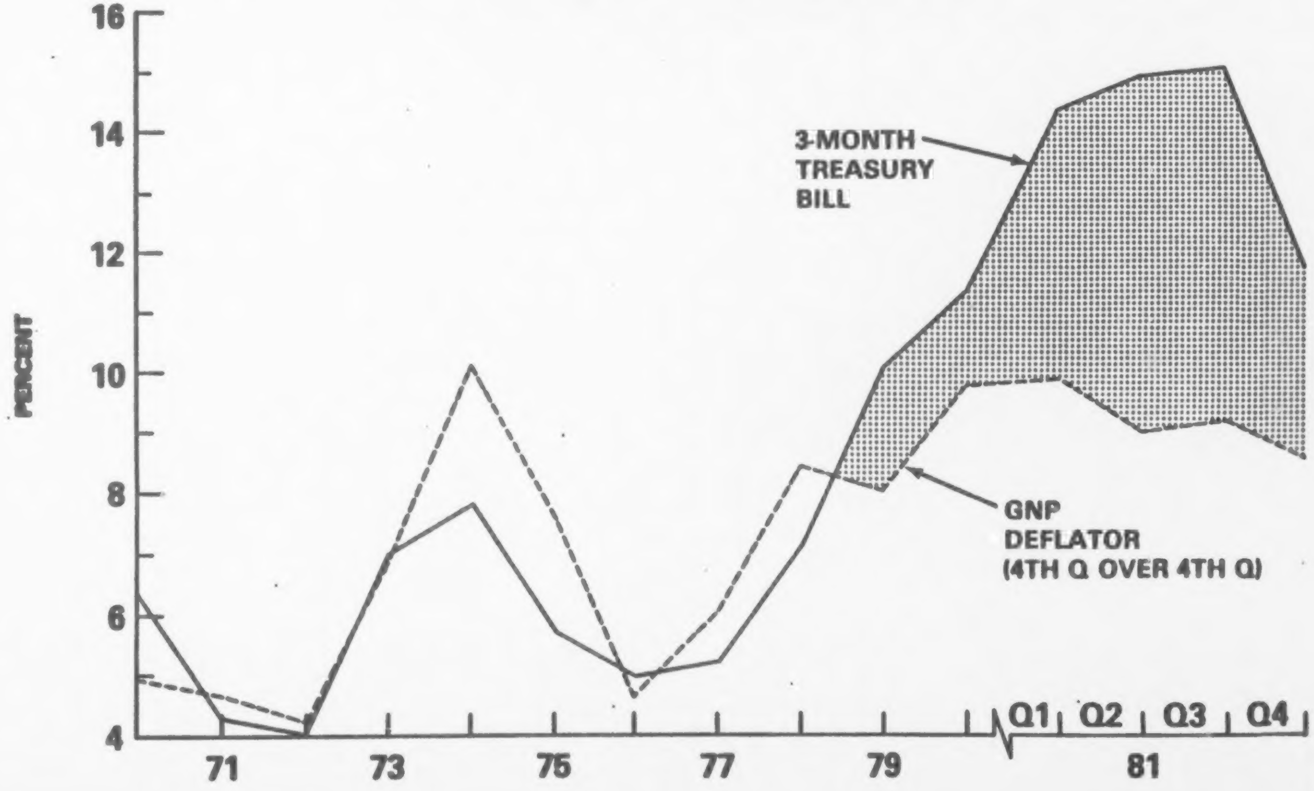
- THROUGHOUT THE 1970'S, THE RISE OF THE INTEREST RATES JUST PARALLELED THE RISE OF INFLATION AND IN MANY YEARS LAGGED BEHIND IT. IN THE T-BILL MARKET, THE AVERAGE REAL INTEREST RATE WAS ACTUALLY NEGATIVE -- MEANING THAT FOR A GOOD PART OF THE DECADE THE FEDERAL DEBT WAS FINANCED AT A NEGATIVE RATE OF RETURN.

- BUT AS THE INFLATION AND FINANCIAL DISORDER WORSENED IN 1979-80, THE FINANCIAL MARKETS ADJUSTED, LONG-TERM LENDING DRIED-UP AND HUGE PREMIUMS ABOVE THE INFLATION RATE APPEARED IN SECURITIES THROUGHOUT THE MATURITY SPECTRUM. THESE PREMIUMS REACHED UNPRECEDENTED SIZE THROUGHOUT 1981.

## CHANGE IN GNP OUTLOOK

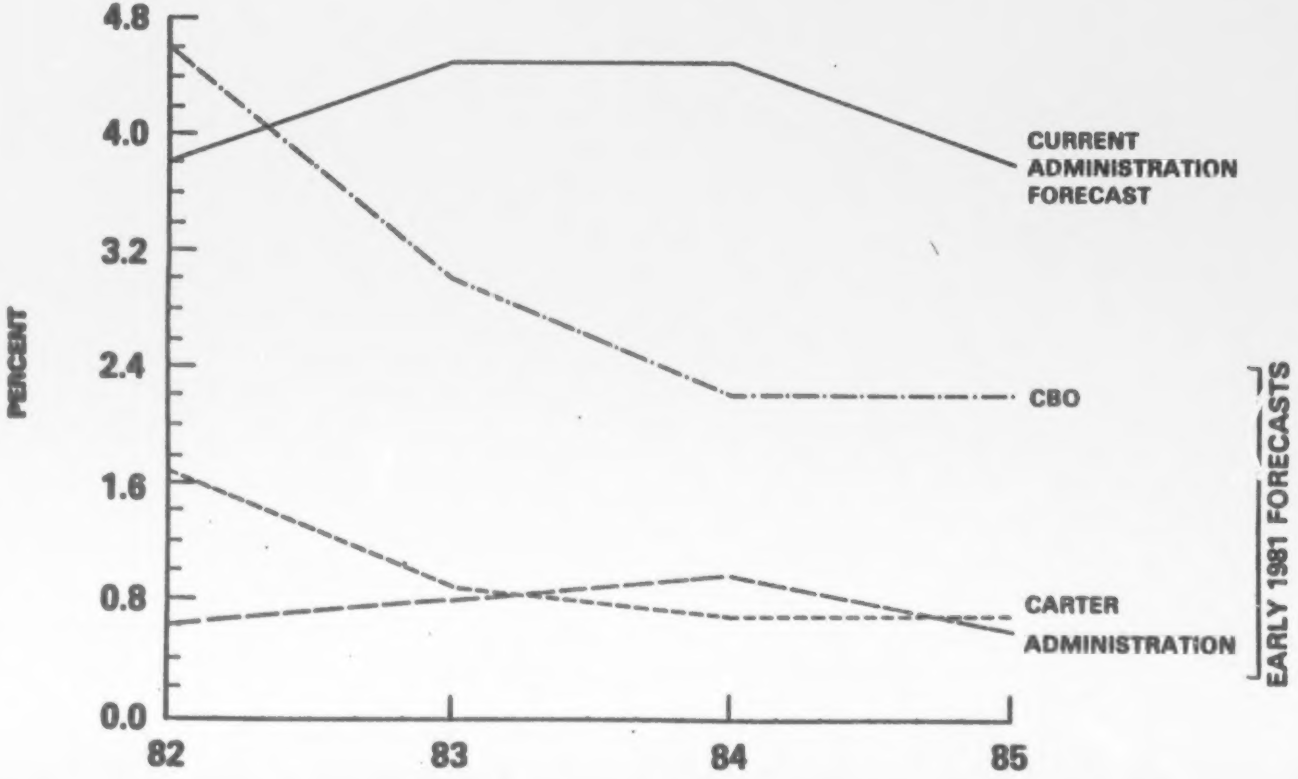


# THE CHANGE IN TREASURY BILL — INFLATION RELATIONSHIP



## INTEREST RATE PREMIUM

(T-BILL RATE MINUS GNP DEFLATOR)



- FORECASTS ISSUED EARLY IN 1981, INCLUDING THE ADMINISTRATION FORECAST, GENERALLY DID NOT ANTICIPATE THE SIZE OF THESE PREMIUMS, NOR DID THEY ANTICIPATE THEY WOULD PERSIST OVER AN EXTENDED DURATION. AS A RESULT, INTEREST RATE LEVELS WERE SERIOUSLY UNDER-ESTIMATED ALONG WITH INTEREST RELATED OUTLAYS.

- IT NOW APPEARS THAT INTEREST RATE PREMIUMS WILL REMAIN "STICKY" DURING THE TRANSITION TO LOWER INFLATION. WHILE PROGRESS IN REDUCING INTEREST RATES CAN BE EXPECTED, IT WILL TAKE TIME TO RESTORE LONG-TERM FINANCIAL CONFIDENCE, REFINANCE SHORT-TERM BUSINESS AND HOUSEHOLD LIABILITIES AND TO BRING CREDIT DEMANDS, INCLUDING GOVERNMENT DEMANDS, AND AVAILABILITY INTO BALANCE.

- AS A CONSEQUENCE, THE ADMINISTRATION'S CURRENT FORECAST ASSUMES SUBSTANTIALLY LARGER INTEREST RATE PREMIUMS OVER THE NEXT SEVERAL YEARS THAN DID ALMOST ALL FORECASTS OF ONE YEAR AGO. RATHER THAN THE TRADITIONAL 1-2 PERCENT INFLATION/INTEREST SPREAD, THE CURRENT ADMINISTRATION FORECAST ASSUMES A 4% OR GREATER SPREAD OR PREMIUM THROUGH 1984, WITH A STEADY DECLINE THEREAFTER.

- GIVEN THE IMPROVING OUTLOOK FOR INFLATION, THE ADMINISTRATION FORECAST NEVERTHELESS PROJECTS A STEADY FALL IN THE INTEREST RATE FROM THE 11.7% T-BILL LEVEL PROJECTED FOR 1982 TO 9.5% BY 1984 AND LOWER THEREAFTER. THIS IS A SUBSTANTIALLY HIGHER PATH THAN PROJECTED LAST YEAR, AND WILL INCREASE INTEREST-RATE RELATED OUTLAYS BY $8 BILLION IN FY 82 AND $54 BILLION OVER FY 83-85.

- WHILE OTHER EARLY 1981 FORECASTS ASSUMED A HIGHER NOMINAL T-BILL RATE, THEY ALSO PROJECTED EXCESSIVE LEVELS OF INFLATION, NOMINAL GNP AND BUDGETARY RECEIPTS. WHEN ALL FORECAST FACTORS ARE REDUCED TO THE BOTTOM LINE -- ADDED DEFICIT AND INCREASED FUTURE YEAR DEBT -- THE CONCLUSION IS THE SAME: DEBT-SERVICE OUTLAYS DUE TO LARGER DEFICITS WILL BE SUBSTANTIALLY HIGHER EVEN IF THE ADMINISTRATION'S COMPLETE BUDGET SAVINGS PROGRAM IS ADOPTED.

OUTLAY INCREASE DUE TO ADDED DEBT RESULTING FROM ALL CHANGES BETWEEN EARLY 1981 FORECASTS AND THE CURRENT ADMINISTRATION FORECAST:

| | FY83 | FY84 | FY85 | TOTAL |
|---|---|---|---|---|
| CARTER - JANUARY................. | 8 | 13 | 17 | 38 |
| CBO - MARCH...................... | 6 | 8 | 10 | 24 |
| ADMINISTRATION - FEBRUARY........ | 16 | 18 | 19 | 53 |
| DRI - FEBRUARY................... | 6 | 10 | 13 | 29 |

## D) THE IMPACT OF ECONOMIC TRANSITION ON THE BUDGET OUTLOOK: CURRENT VS. ORIGINAL ADMINISTRATION PROJECTIONS

- THE FOREGOING MAKES CLEAR THAT THE ORIGINAL ADMINISTRATION ECONOMIC AND BUDGET FORECAST -- ALONG WITH ALL OTHERS ISSUED EARLY LAST YEAR -- DID NOT ANTICIPATE THE GALE-LIKE FORCES THAT A SLOW-DOWN IN MONEY, CREDIT AND NATIONAL INCOME GROWTH, AND THE RESULTING FINANCIAL AND ECONOMIC ADJUSTMENTS, WOULD UNLEASH ON THE BUDGET. IT IS NOW CLEAR THAT THE PROCESS OF DISINFLATION WORKS POWERFULLY AGAINST BUDGETARY EQUILIBRIUM -- AT LEAST FOR AN INTERIM PERIOD OF TIME -- AND THAT THE CHALLENGES OF FISCAL POLICY MANAGEMENT HAVE BECOME DECIDEDLY MORE INTENSE.

- IT IS THIS DISINFLATION PROCESS THAT IS LARGELY RESPONSIBLE FOR THE DRAMATIC DETERIORATION OF THE BUDGET OUTLOOK SINCE LAST YEAR.

- THE MORE ABRUPT THAN EXPECTED SLOW-DOWN IN MONEY GROWTH BETWEEN 1980 AND 1981 (7.2% IN 1980 VS 4.9% IN 1981) IN THE CONTEXT OF ACCUMULATED FINANCIAL WEAKNESS AND DEPRESSED LONG-TERM CAPITAL MARKETS -- TRIPPED THE ECONOMY INTO A TEMPORARY RECESSION AND CORRECTION OF UNDERLYING FINANCIAL AND ECONOMIC IMBALANCES.

- THE RESULTING HIGHER INTEREST RATES AND BORROWING HAVE ADDED $17 BILLION TO FY 82 OUTLAYS. THE RESULTING RECESSION HAS FURTHER REDUCED RECEIPTS BY $31 BILLION AND RAISED UNEMPLOYMENT RELATED OUTLAYS BY $8 BILLION COMPARED TO LAST YEAR'S PROJECTION. THIS $57 BILLION CHANGE DRIVEN BY ECONOMIC FORCES ACCOUNTS FOR THE ENTIRE INCREASE IN THE FY 82 DEFICIT FROM THE ORIGINAL PROJECTIONS. IN ADDITION, THE BUDGETARY SPILL-OVER INTO THE OUT-YEARS FROM THE FY 82 ECONOMIC AND BUDGET DETERIORATION COMPOUNDS THE PROBLEM OF REDUCING FUTURE DEFICITS.

- AS THE RECOVERY GATHERS FORCE THROUGH 1983 AND 1984, THE ANTI-INFLATION MONETARY POLICY WILL IMPOSE A "LID" ON THE RECOVERY OF NOMINAL GNP AND BUDGETARY RECEIPTS. THUS, THE BUDGET RECEIPT PROJECTION HAS BEEN SUBSTANTIALLY REDUCED SINCE LAST YEAR. RECEIPTS WILL BE $53 BILLION LOWER IN FY 83 AND $170 BILLION LOWER OVER FY 83-85. AS A CONSEQUENCE, INHERITED OR NEW SPENDING COMMITMENTS CANNOT BE FINANCED WITH INFLATION-FUELED GROWTH OF RECEIPTS DURING THE RECOVERY PERIOD, AS OCCURRED IN 1975-78 AND PREVIOUS BUSINESS CYCLES.

- THE $249 BILLION IN INDEXED PROGRAMS IN FY 1983 WILL RESPOND TO LOWER INFLATION -- BUT ONLY WITH A LAG DUE TO THE BASE PERIOD ADJUSTMENT MECHANISM. THE DIFFERENCE BETWEEN CONTEMPORANEOUS AND LAGGED ADJUSTMENT WILL INCREASE OUTLAYS BY $5 BILLION IN FY 83 AND $8 BILLION IN FY 85.

- THE RECESSION INDUCED RISE OF UNEMPLOYMENT TO THE 9% RANGE WILL ADD FURTHER PRESSURE TO THE BUDGET -- AS THE RECOVERY SPURRED DROP IN UNEMPLOYMENT WILL START FROM A HIGHER LEVEL AND TAKE LONGER TO REDUCE THAN ANTICIPATED LAST YEAR. SAFETY NET RELATED OUTLAYS WILL BE $14 BILLION HIGHER OVER FY 83-85 AS A CONSEQUENCE.

- THE RESTORATION OF FINANCIAL MARKET CONFIDENCE AND STABILITY WILL TAKE MORE TIME THAN PREVIOUSLY ANTICIPATED, RESULTING IN HIGHER INTEREST RATE PREMIUMS THAN PREVIOUSLY FORECAST. WHILE IT IS EXPECTED THAT T-BILL RATES WILL STEADILY FALL FROM CURRENT PEAKS, T-BILL LEVELS OVER FY 83-85 ARE NOW PROJECTED TO AVERAGE 260 BASIS POINTS HIGHER THAN PROJECTED LAST YEAR. THIS WILL INCREASE INTEREST-RATE RELATED OUTLAYS BY $15 BILLION IN FY 83 AND $54 BILLION OVER THE THREE-YEAR PERIOD.

- ALL OF THESE FORCES ACTING TOGETHER ADD TO CURRENT YEAR DEFICITS AND RAISE THE AMOUNT OF DEBT TO BE FINANCED IN OUT-YEARS. EVEN ASSUMING FULL ENACTMENT OF THE FY 83 BUDGET PROGRAM, ADDED INTEREST AND DEBT SERVICE OUTLAYS WILL REACH $31 BILLION IN FY 83 AND $107 BILLION OVER FY 83-85, COMPARED TO LAST YEAR'S FORECAST.

- THE HUGE DIFFERENCES IN BUDGET AND DEFICIT ESTIMATES SHOWN IN THE TABLE DUE TO THE CHANGE IN THE ECONOMIC OUTLOOK SINCE LAST FEBRUARY ARE NOT UNIQUE TO THE ADMINISTRATION'S ORIGINAL FORECAST, AS WAS DEMONSTRATED PREVIOUSLY.

COMPARISON OF FEBRUARY 1981 AND CURRENT ADMINISTRATION ECONOMIC ASSUMPTIONS
(CALENDAR YEAR, DOLLAR AMOUNTS IN BILLIONS)

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|---|
| NOMINAL GNP: | | | | | | |
| 1981 FORECAST................ | 2,920 | 3,293 | 3,700 | 4,098 | 4,500 | 4,918 |
| 1982 FORECAST................ | 2,922 | 3,160 | 3,524 | 3,883 | 4,258 | 4,651 |
| REAL GNP (PERCENT CHANGE): | | | | | | |
| 1981 FORECAST................ | 1.1 | 4.2 | 5.0 | 4.5 | 4.2 | 4.2 |
| 1982 FORECAST................ | 2.0 | 0.2 | 5.2 | 5.0 | 4.7 | 4.4 |
| GNP DEFLATOR (PERCENT CHANGE): | | | | | | |
| 1981 FORECAST................ | 9.9 | 8.3 | 7.0 | 6.0 | 5.4 | 4.9 |
| 1982 FORECAST................ | 9.1 | 7.9 | 6.0 | 5.0 | 4.7 | 4.6 |
| INTEREST RATE ON 91-DAY TREASURY BILLS (PERCENT): | | | | | | |
| 1981 FORECAST................ | 11.1 | 8.9 | 7.8 | 7.0 | 6.0 | 5.6 |
| 1982 FORECAST................ | 14.1 | 11.7 | 10.5 | 9.5 | 8.5 | 7.0 |
| UNEMPLOYMENT RATE (PERCENT). | | | | | | |
| 1981 FORECAST................ | 7.8 | 7.2 | 6.6 | 6.4 | 6.0 | 5.6 |
| 1982 FORECAST................ | 7.6 | 8.9 | 7.9 | 7.1 | 6.4 | 5.8 |

EFFECTS ON THE BUDGET OF CHANGES IN ECONOMIC ASSUMPTIONS SINCE MARCH 1981
(IN BILLIONS OF DOLLARS)

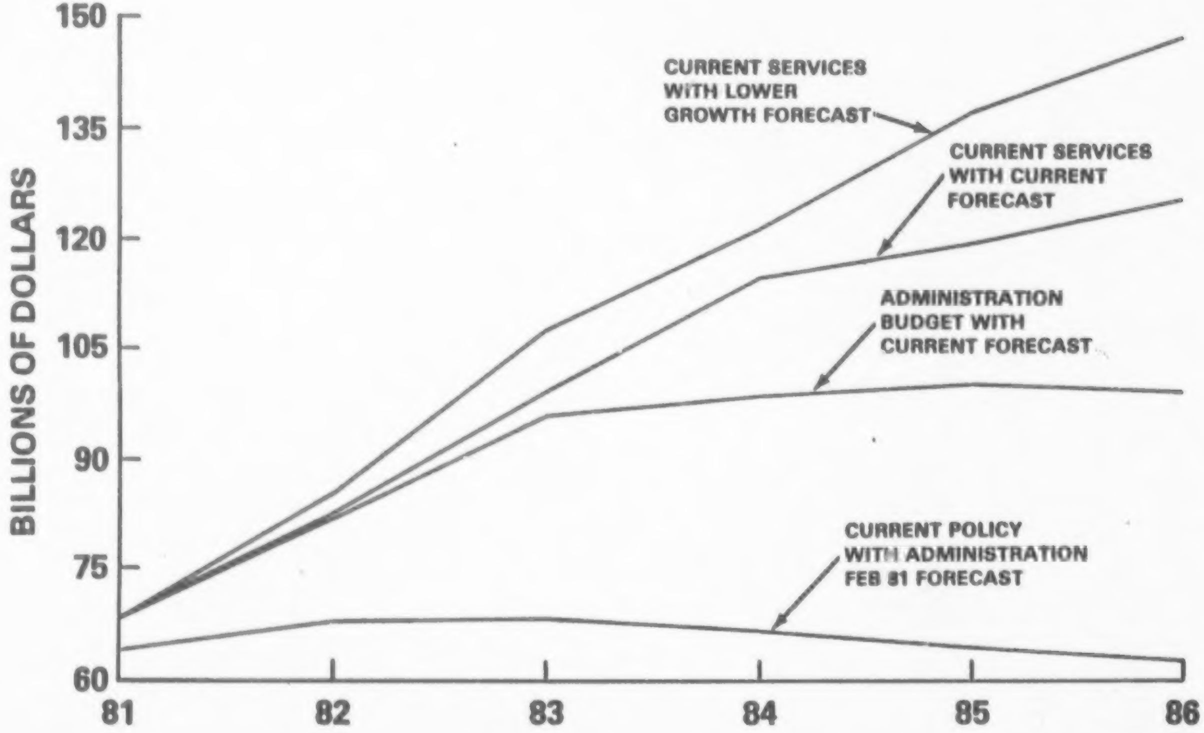
| | 1982 | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|---|
| Current Budget Estimates Adjusted to March 1981 forecast: | | | | | |
| Receipts | 657.7 | 718.7 | 779.7 | 856.9 | 922.7 |
| Outlays | 699.4 | 721.1 | 771.2 | 836.1 | 897.5 |
| Deficit (-) | -41.7 | -2.4 | 8.5 | 20.8 | 25.2 |
| Changes Due to Economic Assumptions: | | | | | |
| Receipts | -31.0 | -52.6 | -56.7 | -60.3 | -61.7 |
| Outlays: | | | | | |
| Inflation | 1.5 | -2.1 | -5.7 | -9.8 | -11.9 |
| Unemployment | 7.9 | 7.4 | 4.4 | 2.3 | 0.9 |
| Interest Rates and Deficits | 16.6 | 31.1 | 36.0 | 39.8 | 40.5 |
| Total | 25.9 | 36.5 | 34.7 | 32.4 | 29.5 |
| Total Increase in Deficit (-) | -56.9 | -89.1 | -91.4 | -92.6 | -91.2 |
| Current Budget Estimates: | | | | | |
| Receipts | 626.8 | 666.1 | 723.0 | 796.6 | 861.0 |
| Outlays | 725.3 | 757.6 | 805.9 | 868.5 | 927.0 |
| Deficit (-) | -98.6 | -91.5 | -82.9 | -71.9 | -66.0 |

E) THE POTENTIAL EXPLOSION OF DEBT SERVICES COSTS

o CHANGES IN CURRENT AND EXPECTED ECONOMIC CONDITIONS ACCOUNT FOR THE HIGH DEFICITS PROJECTED EVEN AFTER THE ADMINISTRATION'S FY 83 BUDGET SAVINGS PROGRAM. BUT IT MUST BE CLEARLY RECOGNIZED THAT THESE DEFICIT INCREASING FORCES HAVE AN EXPLOSIVE POTENTIAL FOR FURTHER EXACERBATING THE BUDGET IMBALANCE IF DECISIVE AND COMPREHENSIVE DEFICIT REDUCTION ACTIONS ARE NOT IMPLEMENTED THIS YEAR.

o THE INCREASED INTEREST RATES AND DEBT FINANCING REQUIREMENTS FOR FY 83-85 ADD $94 BILLION TO THE PROJECTION OF NET INTEREST OUTLAYS COMPARED TO LAST FEBRUARY. IF NO ACTION IS TAKEN ON THE FY 83 BUDGET SAVINGS PROGRAM, NET INTEREST OUTLAYS OVER THE THREE YEARS WILL RISE BY ANOTHER $33 BILLION. AND IF ECONOMIC PERFORMANCE WEAKENS UNDER THE BURDEN OF THESE DEBT FINANCING REQUIREMENTS TO THE LOWER-GROWTH/HIGHER INFLATION SCENARIO DESCRIBED ON PAGE 4 -- ANOTHER $37 BILLION WOULD BE ADDED TO DEBT SERVICE COSTS OVER THE NEXT THREE YEARS.

## POTENTIAL EXPLOSION OF DEBT — SERVICE OUTLAYS



## IV. THE FISCAL POLICY ALTERNATIVES CONSIDERED BY CONGRESS LAST YEAR WOULD HAVE HAD A SIMILAR IMPACT ON THE CURRENT BUDGET OUTLOOK: SIMILAR, LARGE CURRENT SERVICES DEFICITS RESULT FROM EITHER THE ADMINISTRATION PROGRAM AS ADOPTED OR THE HOUSE WAYS AND MEANS AND BUDGET COMMITTEE TAX AND SPENDING POLICY ALTERNATIVES THAT WERE REJECTED.

- THE TABLE BELOW PROVIDES A CURRENT SERVICES PROJECTION OF MAJOR SPENDING AND TAX POLICY OPTIONS CONSIDERED AND REJECTED BY THE CONGRESS LAST YEAR COMPARED TO THE CURRENT SERVICES PROJECTION OF THE ADMINISTRATION PROGRAM AS ENACTED. BOTH BUDGET PROJECTIONS ARE BASED ON THE CURRENT ADMINISTRATION ECONOMIC FORECAST.

- HAD THE FIRST BUDGET RESOLUTION SPENDING POLICY RECOMMENDATIONS PROPOSED BY THIS COMMITTEE LAST YEAR BEEN ADOPTED, AGGREGATE CURRENT SERVICES OUTLAY PROJECTIONS WOULD HAVE BEEN SIMILAR -- EXCEPT FOR A MODEST RE-ALLOCATION OF OUTLAYS FROM DEFENSE TO NON-DEFENSE PROGRAMS.

- HAD THE WAYS AND MEANS COMMITTEE TAX BILL HAVE BEEN ADOPTED, THE THIRD-YEAR OF THE INDIVIDUAL RATE CUT WOULD NOT LIKELY BE TRIGGERED IN JANUARY 1984 AS PROVIDED BY THE BILL. NEVERTHELESS, DUE TO OTHER PROVISIONS OF THE WAYS AND MEANS ALTERNATIVE THE FY 82-84 STATIC REVENUE COST WOULD HAVE BEEN SIMILAR:

| | ($ BILLIONS) |
|---|---|
| ECONOMIC RECOVERY TAX ACT REVENUE COST, FY 82-84...................... | $-269 |
| WAYS AND MEANS TAX ALTERNATIVE FY 82-84 WITHOUT THIRD YEAR RATE CUT................. | $-253 |

- AS A CONSEQUENCE, CURRENT SERVICES DEFICIT PROJECTIONS FOR FY 82-84 ARE NEARLY IDENTICAL WHEN BASED ON COMMON ECONOMIC ASSUMPTIONS. IN BOTH CASES, A LARGE, UNANTICIPATED FISCAL PROBLEM LOOMS ON THE HORIZON DUE TO CHANGED ECONOMIC CIRCUMSTANCES AND OUTLOOK.

- THE DEFICIT CAN BE REDUCED IF THE DEBATE FOCUSES ON THE COMMON PROBLEM AT HAND AND THE POTENTIAL BUDGET SAVINGS OPTIONS AVAILABLE. RE-OPENING THE DEBATE ON PAST POLICY CHOICES -- BOTH OF WHICH APPROPRIATELY AND IRREVERSIBLY MOVED THE NATION FORWARD ON A CONSTRUCTIVE PATH OF LOWER TAXES AND REDUCED SPENDING GROWTH -- WILL NEITHER SOLVE NOR EXPLAIN OUR CURRENT FISCAL POLICY CHALLENGES.

## CURRENT SERVICES BUDGET ESTIMATES: ENACTED ADMINISTRATION PROGRAM VS. 1981 CONGRESSIONAL ALTERNATIVES

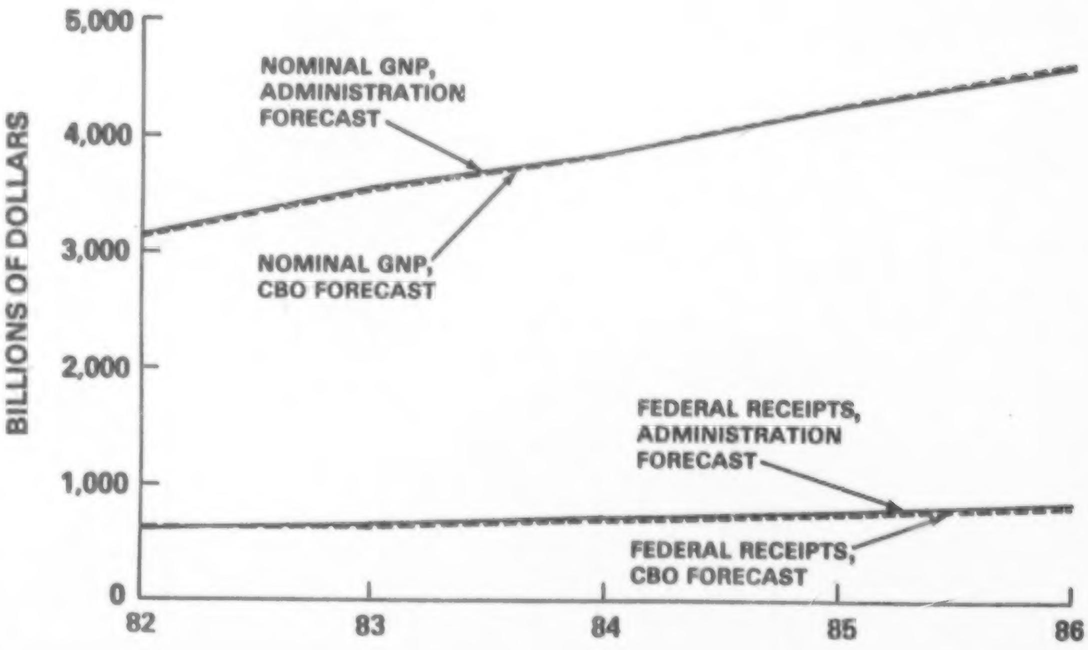
(BILLIONS OF $)

| | FY-82 | FY-83 | FY-84 |
|---|---|---|---|
| **Outlays:** | | | |
| Administration Current Services Estimate: | 728 | 799 | 869 |
| Policy Differences in 1981 HBC First Budget Resolution: | | | |
| Non-Defense Increases | +7 | +7 | +7 |
| Defense Reductions | -- | -5 | -6 |
| Current Services Estimate with HBC Spending Policy Alternative | 735 | 801 | 870 |
| **Receipts:** | | | |
| Administration Current Services Estimate: | 626 | 653 | 704 |
| Policy Differences in 1981 Ways and Means Tax Alternative | + 2 | - 2 | +17 |
| Current Services Receipts with Ways and Means Tax Alternative | 628 | 651 | 721 |
| **Deficit:** | | | |
| Administration Current Services Deficit | -102 | -147 | -167 |
| Current Services Deficit with HBC Spending and Ways and Means Tax Alternative | -107 | -150 | -149 |

## V. THE 1982 FORECAST ISSUES: CBO VS. ADMINISTRATION ASSUMPTIONS

- o ON THE MAJOR VARIABLE WHICH DRIVES THE BUDGET AND DEFICIT -- NOMINAL GNP -- THERE ARE NO SIGNIFICANT DIFFERENCES BETWEEN THE ADMINISTRATION AND CBO FORECASTS. GNP LEVELS AND CURRENT LAW RECEIPT ESTIMATES ARE NEARLY IDENTICAL FOR FY 82-84, WITH CBO SOMEWHAT LOWER IN FY 85. AS NOTED PREVIOUSLY, BOTH EMBODY SUBSTANTIAL DOWNWARD ESTIMATES FROM LAST YEAR'S ASSUMPTIONS.

# IMPACT OF ADMINISTRATION AND CBO FORECASTS: DIFFERENCE ON GNP AND RECEIPTS



- A SIGNIFICANT DIFFERENCE IN TERMS OF BUDGETARY IMPACT IS FOUND IN THE COMPOSITION OF NOMINAL GNP -- THE SPLIT BETWEEN REAL GROWTH AND INFLATION. ESSENTIALLY, CBO ASSUMES A SIGNIFICANTLY LOWER REAL GROWTH RATE AND A HIGHER INFLATION RATE.

- FOR THE SIX INITIAL RECOVERY QUARTERS BEGINNING IN 1982:3, THE ADMINISTRATION AND CBO GNP GROWTH RATES COMPARE WITH HISTORICAL RECOVERY PERIODS AS FOLLOWS:

| | AVERAGE REAL GNP GROWTH, SIX INITIAL RECOVERY QUARTERS |
|---|---|
| ADMINISTRATION........................... | 5.4% |
| CBO...................................... | 4.5 |
| 1975 - 1976.............................. | 5.3 |
| 1970 - 1971.............................. | 5.6 |
| 1961 - 1962.............................. | 6.0 |
| 1958 - 1959.............................. | 5.7 |
| AVERAGE, ALL POST-WAR RECOVERIES.......... | 5.6% |

- FOR THE ENTIRE 22 QUARTER PERIOD OF REAL EXPANSION BEGINNING IN 1982:2 THROUGH 1987, THE ADMINISTRATION AND CBO FORECASTS COMPARE AS FOLLOWS:

| | 22 QUARTER AVERAGE REAL GROWTH (%) |
|---|---|
| ADMINISTRATION........................... | 4.7 |
| CBO...................................... | 3.1 |
| AVERAGE, 1947 - 1981..................... | 3.5 |
| AVERAGE, 1961 - 1966..................... | 5.4 |

- COMPARED WITH ALL TWENTY-TWO-QUARTER PERIODS (118 SEPARATE OBSERVATIONS) BETWEEN 1947 - 1981, THE CBO AND ADMINISTRATION REAL GROWTH FORECASTS COMPARE AS FOLLOWS:

| | NUMBER OF PERIODS ABOVE | NUMBER OF PERIODS BELOW |
|---|---|---|
| ADMINISTRATION........................... | 22 | 96 |
| CBO...................................... | 73 | 45 |

- BOTH THE ADMINISTRATION AND CBO FORECASTS ASSUME SUBSTANTIAL INTEREST PREMIUMS OVER THE 1983-85 PERIOD. HOWEVER, SINCE THE CBO FORECAST ASSUMES LOWER GROWTH AND HIGHER INFLATION, CBO T-BILL LEVELS ARE SUBSTANTIALLY HIGHER IN EACH OF THE THREE YEARS:

INTEREST PREMIUM (%)

| | 1983 | 1984 | 1985 |
|---|---|---|---|
| CBO...................... | 5.9 | 4.7 | 3.4 |
| ADMINISTRATION........... | 4.5 | 4.5 | 3.8 |

T-BILL LEVEL (%)

| | 1983 | 1984 | 1985 |
|---|---|---|---|
| CBO...................... | 13.2 | 11.3 | 9.4 |
| ADMINISTRATION........... | 10.5 | 9.5 | 8.5 |

- THE OVERALL IMPACT ON THE BUDGET AND DEFICIT PROJECTIONS OF THESE DIFFERENCES IN FORECAST ASSUMPTIONS IS MODEST FOR FY 82-83, BUT OF SIGNIFICANT MAGNITUDE FOR FY 83-84:

| | FY 82 | FY 83 | FY 84 | FY 85 |
|---|---|---|---|---|
| ADMINISTRATION DEFICIT ESTIMATE...... | -98.6 | -91.5 | -82.9 | -71.9 |
| WITH CBO ECONOMIC ASSUMPTIONS........ | -104.5 | -98.8 | -104.7 | -103.7 |
| DIFFERENCE...................... | 5.9 | 7.3 | 21.8 | 31.8 |

- WHILE THESE CURRENT FORECAST DIFFERENCES HAVE SIGNIFICANT BUDGETARY IMPACT IN THE OUT-YEARS, THEIR MAGNITUDE IS SUBSTANTIALLY OVER-SHADOWED BY THE DEFICIT IMPACT OF THE ADMINISTRATION'S FIVE-PART BUDGET SAVINGS PLAN. THUS, FORECAST ISSUES ARE IMPORTANT, BUT THE ULTIMATE SIZE OF THE DEFICIT AND ITS IMPACT ON THE ECONOMIC RECOVERY WILL DEPEND UPON SUCCESSFUL POLICY ACTION TO REFORM ENTITLEMENTS, HOLD-DOWN DISCRETIONARY SPENDING, ELIMINATE TAX LOOPHOLES AND IMPLEMENT USER FEES AND MANAGEMENT INITIATIVES:

| | FY-83 | FY-84 | FY-85 | TOTAL FY-83-85 |
|---|---|---|---|---|
| DEFICIT ADD-ON DUE TO CBO ECONOMIC ASSUMPTIONS.................... | +7 | +22 | +32 | +61 |
| DEFICIT REDUCTION DUE TO ADMINISTRATION FIVE-PART BUDGET SAVINGS PROGRAM........ | -56 | -84 | -99 | -239 |

## ADMINISTRATION BUDGET REESTIMATED FOR CBO ECONOMIC ASSUMPTIONS

| | 82 | 83 | 84 | 85 |
|---|---|---|---|---|
| I. Outlays | | | | |
| Administration Outlays | 725.3 | 757.6 | 805.9 | 868.5 |
| Re-estimates for CBO Assumptions: | | | | |
| Higher Interest Rates | 1.0 | 1.5 | 11.1 | 9.2 |
| Higher Debt | 0.2 | 1.1 | 2.4 | 5.3 |
| Higher Unemployment | -- | 1.2 | 2.2 | 4.7 |
| Higher Inflation | -- | 1.2 | 5.5 | 14.9 |
| Outlays with CBO Assumptions 1/ | 726.5 | 762.6 | 827.1 | 902.6 |
| II. Receipts | | | | |
| Administration Receipts | 626.8 | 666.1 | 723.0 | 796.6 |
| Re-estimates for CBO Economic Assumptions | -4.8 | -2.3 | -0.6 | 2.3 |
| Receipts with CBO Assumptions 1/ | 622.0 | 663.8 | 722.4 | 798.9 |
| III. Deficit | | | | |
| Administration Estimate | -98.6 | -91.5 | -82.9 | -71.9 |
| Re-estimate with CBO Economic Assumptions 1/ | -104.5 | -98.8 | -104.7 | -103.7 |

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1/ NOTE: OMB estimates for economic assumption differences only. Does not reflect differences in technical estimates.

## VI. THE PRESIDENT'S FY 83 BUDGET SAVINGS PROGRAMS

- IN AN EFFORT TO MEET HEAD-ON THIS DETERIORATION OF THE FISCAL SITUATION, THE PRESIDENT'S FY 83 BUDGET PROPOSES A BALANCED, COMPREHENSIVE AND SUBSTANTIAL PROGRAM TO CLOSE THE UNANTICIPATED BUDGET GAP. THE BUDGET SAVINGS PROGRAM:
  - REDUCES THE FY 83 DEFICIT BY $56 BILLION -- WITH ANNUAL SAVINGS RISING TO $99 BILLION BY FY 85.
  - REDUCES THE OVERALL CURRENT SERVICES DEFICIT BY $239 BILLION OR 50% OVER THE FY 83-85 PERIOD.
  - ENSURES THAT THE DEFICIT WILL DECLINE STEADILY FROM THE FY 82 RECESSION PEAK, AND THAT DEFICITS DURING THE RECOVERY PERIOD FY 83-85 WILL NOT EXCEED HISTORIC LEVELS RELATIVE TO GNP OR TO TOTAL CREDIT AND CAPITAL AVAILABILITY.

# FIVE-PART BUDGET SAVINGS PLAN
## — FY '83-85 —

(BILLIONS OF DOLLARS)

| | FY '83 | FY '84 | FY '85 | TOTAL | SHARE |
|---|---|---|---|---|---|
| ENTITLEMENT REFORMS | 11.7 | 17.1 | 22.8 | 51.6 | 22% |
| USER FEES | 2.5 | 3.5 | 3.8 | 9.8 | 4% |
| DISCRETIONARY PROGRAM CUTS | 14.2 | 26.1 | 35.3 | 75.6 | 32% |
| MANAGEMENT INITIATIVES | 20.3 | 24.0 | 23.9 | 68.2 | 28% |
| TAX REVISIONS | 7.2 | 13.5 | 13.5 | 34.1 | 14% |
| TOTAL | 55.9 | 84.1 | 99.3 | 239.3 | 100% |

## KEY ENTITLEMENT REFORMS

### MEDICAL CARE

- o PROVIDER REIMBURSEMENT SAVINGS
- o CO-PAYMENTS AND INDEXING OF DEDUCTIBLE
- o FEDERAL EMPLOYEE COVERAGE -- HI TAX
- o PRO-COMPETITION COST CONTAINMENT PLAN -- LATER TRANSMITTAL

### CASH ASSISTANCE

- o SSI -- MEDICAL DISABILITY AND 24 MONTH PROGNOSIS
- o AFDC -- TIGHTEN WORKFARE, BROADEN INCOME TESTS

### FEDERAL RETIREMENT

- o LOWER OF FEDERAL PAY RAISE OR CPI
- o LIMIT COLA TO LESS THAN CPI WHERE ANNUITIES EXCEED CURRENT RETIREMENT LEVELS

### FOOD STAMPS AND NUTRITION

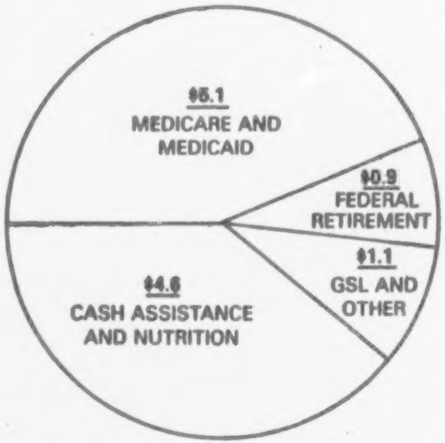
- o RAISE INCOME CONTRIBUTION FOR FOOD FROM 30% TO 35%
- o ELIMINATE EARNED INCOME DISREGARD
- o BENEFIT ROUNDING, MANDATORY JOB SEARCH
- o ELIMINATE SPECIAL MILK AND SUMMER FEEDING

### GUARANTEED STUDENT LOANS

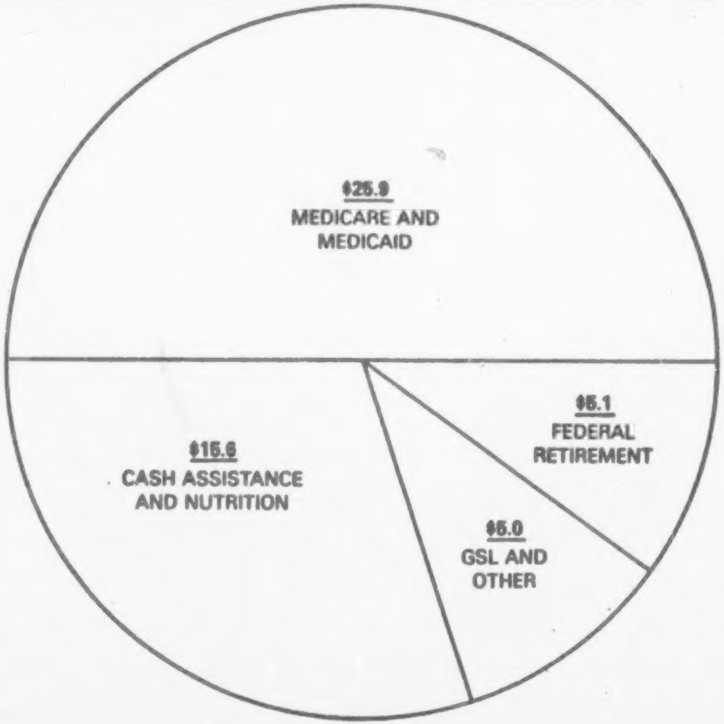
- o RAISE ORIGINATION FEE FROM 5% TO 10%
- o TIGHTEN AND APPLY NEEDS TEST TO ALL APPLICANTS
- o ELIMINATE FULL INTEREST SUBSIDY FOR GRADUATE STUDENTS

# ENTITLEMENT REFORMS

(BILLIONS OF DOLLARS)



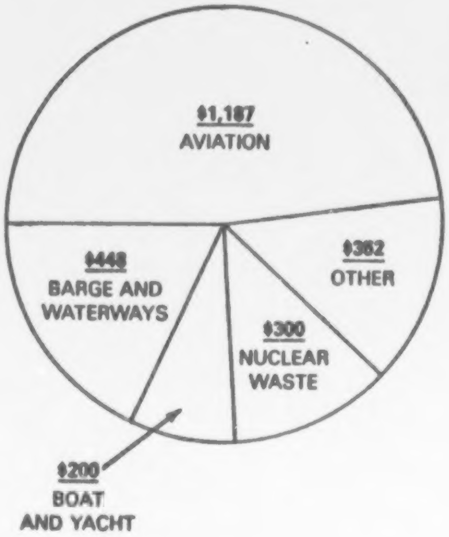
FY '83: $11.7



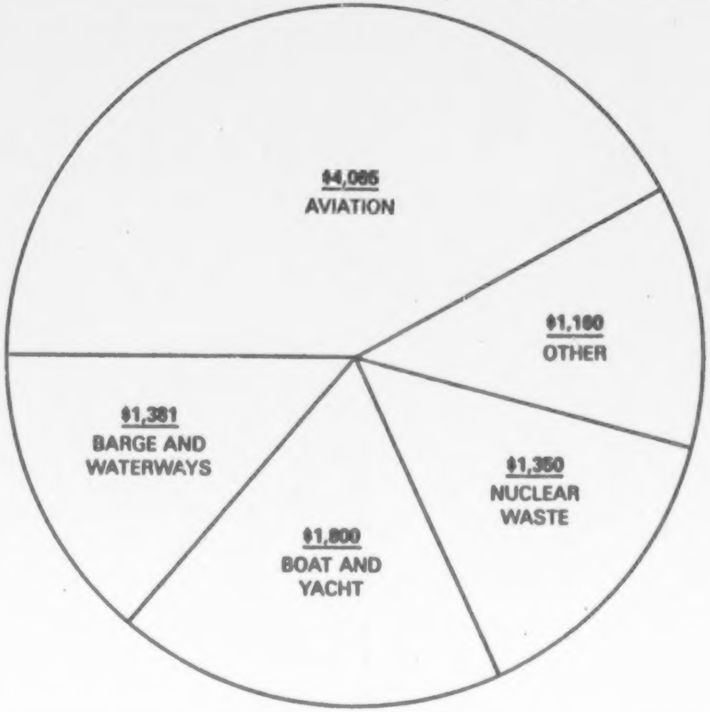
FY '83-85: $51.6

# USER FEES

(MILLIONS OF DOLLARS)



FY '83: $2,487



FY '83 - '85: $9,776

## USER FEE INITIATIVE

FIFTEEN NEW, INCREASED OR RE-PROPOSED USER FEES WOULD YIELD $2.5 BILLION IN FY 83 RISING TO $3.8 BILLION BY FY 85

- AVIATION USER FEES TO RECOVER 85% OF AIR TRAFFIC CONTROL SYSTEM COSTS FINANCED WITH 8% PASSENGER TICKET TAX AND INCREASED GENERAL AVIATION GASOLINE AND JET FUEL TAXES
- CORPS OF ENGINEERS NAVIGATION FEES TO RECOVER NEW CONSTRUCTION AND MAINTENANCE EXPENSES FOR COMMERCIAL PROJECTS
- COMMERCIAL NUCLEAR WASTE DISPOSAL TO ESTABLISH AN INDEPENDENT AND SELF-FINANCING WASTE DISPOSAL OPERATION -- $300 MILLION IN INITIAL YEAR
- COAST GUARD USER FEES FOR LICENSES, INSPECTIONS, NAVIGATION AIDS AND SEARCH AND RESCUE MISSIONS
- RECREATION FEES FOR PARK ENTRY AND USE OF FACILITIES
- PATENTS AND TRADEMARK FEES TO COVER APPLICATION PROCESSING COSTS AND TO OFFSET THE COSTS OF PATENT AND TRADEMARK OFFICE (PTO).

## MANAGEMENT INTIATIVES

### IRS COLLECTION AND ENFORCEMENT

- 5200 ADDITIONAL IRS STAFF TO REDUCE DELINQUENT ACCOUNT BACKLOG, INCREASE AUDIT COVERAGE OF LARGE COMPANIES, AND IDENTIFY NON-FILERS
- WITHHOLDING OF TAXES ON INTEREST AND DIVIDENDS
- ACCELERATION OF CORPORATE TAX COLLECTION TO 90% OF ESTIMATED LIABILITY

### FEDERAL PAY RESTRAINT

- LIMIT PAY RAISE TO 5%

### ACCELERATED OFF-SHORE LEASING

- THE ADMINISTRATION'S ACCELERATED OCS LEASING PROGRAM IS EXPECTED TO RESULT IN AN AVERAGE OF 5.7 MILLION ACRES PER YEAR IN SALES, WHICH IS MORE THAN DOUBLE THE AVERAGE UNDER THE CARTER SCHEDULE
- WILL RESULT IN INCREASED BONUS PAYMENTS THAT NEARLY DOUBLE PROJECTED RECEIPTS FROM OCS BONUS AND ROYALTY PAYMENTS TO A TOTAL OF $18 BILLION IN FY 83

## MANAGEMENT INITIATIVES
(CONTINUED)

### SURPLUS PROPERTY DISPOSAL

- SURPLUS GSA PROPERTY TRANSFERRED TO OTHER AGENCIES ONLY AT MARKET VALUE, NOT FREE AS CURRENT PRACTICE
- HIGH-LEVEL PROPERTY REVIEW BOARD TO OVERSEE REAL PROPERTY MANAGEMENT, IDENTIFICATION OF UNNEEDED HOLDINGS AND SPEEDY DISPOSAL WHEREVER POSSIBLE
- DISPOSE OF TENS OF MILLIONS OF ACRES OF PUBLIC LAND WITH NO UNIQUE WILDERNESS, RECREATIONAL OR HISTORIC SIGNIFICANCE, INCLUDING PARCELS ADJACENT TO NEWLY URBANIZED AREAS, AND SMALL, ISOLATED TRACTS TOO COSTLY TO MANAGE

### DEBT COLLECTION

- 24 AGENCIES WILL HAVE COMPREHENSIVE COLLECTION PLANS AND TARGETS -- INCLUDING INCREASED TRAINING, ACCOUNTABILITY AND IMPROVED TECHNIQUES
- NEW LEGISLATIVE AUTHORITY INCLUDING FURNISHING OF SOCIAL SECURITY NUMBERS, BROADER AUTHORITY TO CONTRACT OUT, POWER TO ASSESS INTEREST AND PENALTIES ON OVERDUE ACCOUNTS AND TO REFER INFORMATION ON DELINQUENT DEBTORS TO CREDIT BUREAUS

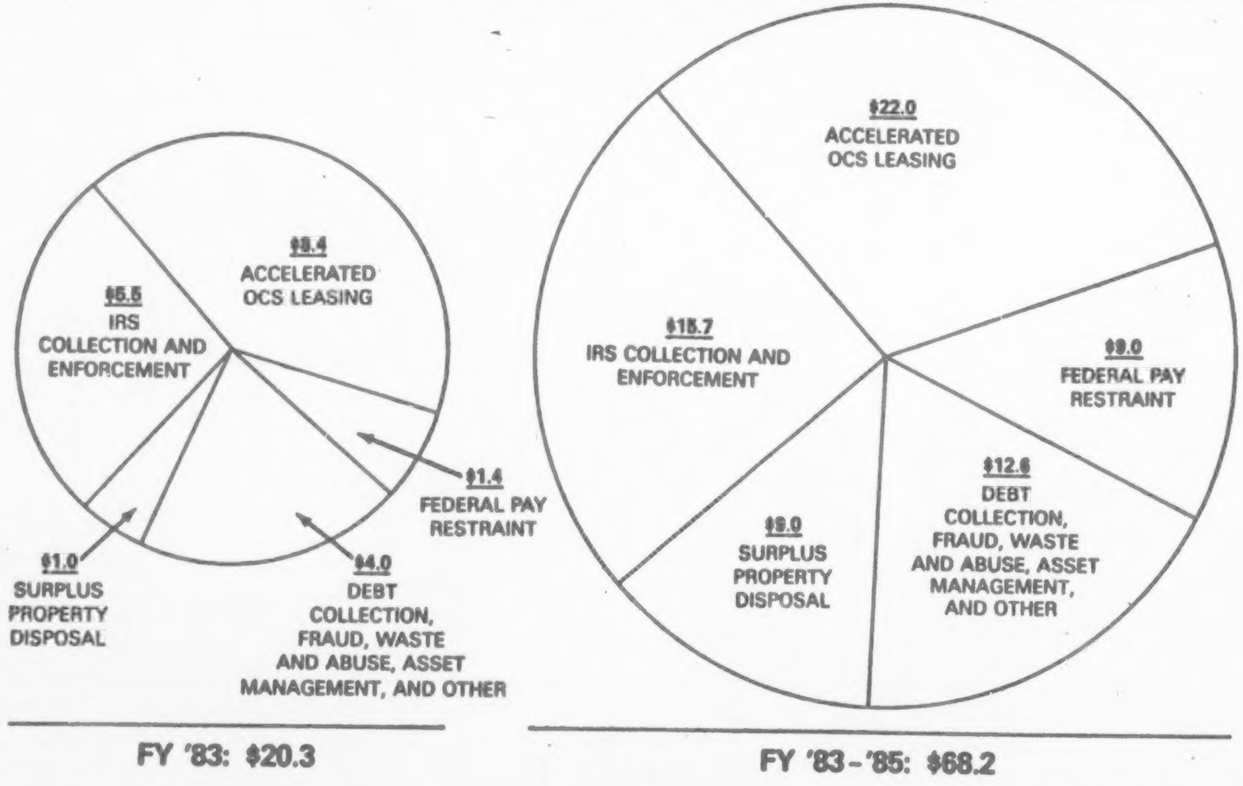
## TAX REVISIONS

CHANGES ARE DESIGNED TO ELIMINATE ABUSES, REMOVE OBSOLETE INCENTIVES, CORRECT UNINTENDED LOOPHOLES, AND REQUIRE PROFITABLE BUSINESS TO CONTRIBUTE AT LEAST SOME MINIMUM FAIR SHARE.

- DISALLOW COMPLETED CONTRACT METHOD OF TAX ACCOUNTING. TAXPAYERS WILL BE REQUIRED TO USE EITHER THE PERCENTAGE OF COMPLETION METHOD OR THE PROGRESSIVE PAYMENT METHOD OF ACCOUNTING FOR LONG-TERM CONTRACTS.
- REPEAL ALL BUSINESS ENERGY TAX SUBSIDIES AND SPECIAL PROVISIONS ALLOWING STATES AND LOCALITIES TO ISSUE TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS TO FINANCE CERTAIN ENERGY PROJECTS.
- ASSETS FINANCED WITH TAX-EXEMPT REVENUE BONDS ISSUED AFTER 1982 MUST BE DEPRECIATED USING THE STRAIGHT LINE METHOD. TAX-EXEMPT REVENUE BOND FINANCING WILL BE LIMITED TO BONDS THAT ARE PUBLICLY APPROVED AND AFTER 1985, RECEIVE A FINANCIAL COMMITMENT FROM THE LOCAL GOVERNMENT. SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS WILL NOT BE ALLOWED FOR LARGE BUSINESSES.
- REPEAL UNINTENDED WINDFALL FROM MODIFIED CO-INSURANCE TAX ACCOUNTING RULES.
- AMORTIZE CONSTRUCTION PERIOD INTEREST AND TAXES INCURRED BY CORPORATIONS TO DEVELOP NON-RESIDENTIAL REAL PROPERTY. COSTS WILL BE RECOVERED OVER TEN YEARS.
- TO THE ADD-ON MINIMUM TAX WILL BE REPLACED WITH A 15% ALTERNATIVE MINIMUM TAX THAT WOULD APPLY ONLY TO THOSE CORPORATIONS THAT PAY VERY LOW REGULAR TAX RATES.

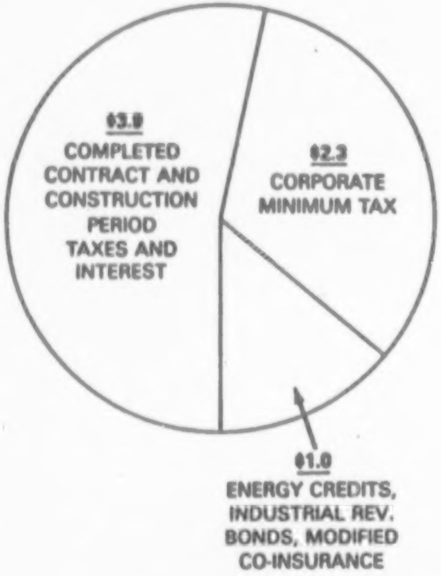
# MANAGEMENT INITIATIVES

(BILLIONS OF DOLLARS)

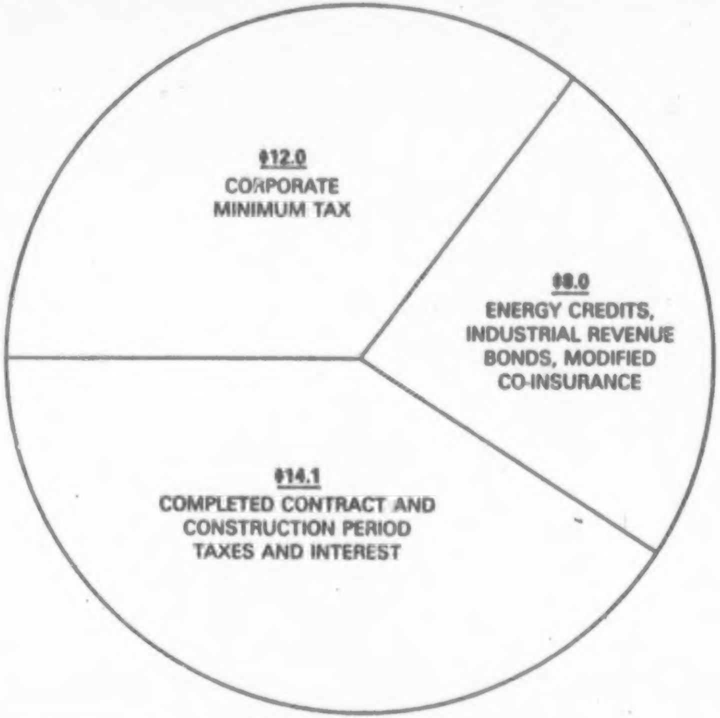


# TAX REVISIONS

(BILLIONS OF DOLLARS)



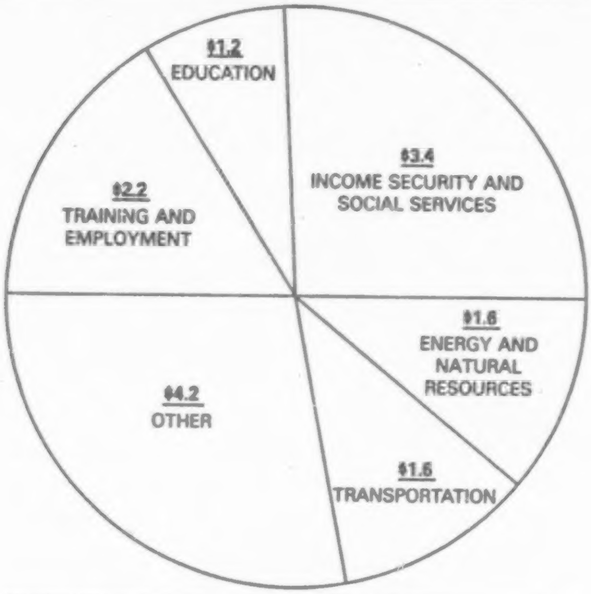
FY '83: $7.2



FY '83 - '85: $34.1

## DISCRETIONARY PROGRAMS

(BILLIONS OF DOLLARS)



TOTAL: $14.2

### DISCRETIONARY PROGRAMS

- IN EVALUATING THE ADMINISTRATION'S PROPOSALS IN THE DISCRETIONARY SPENDING AREA, IT IS IMPORTANT TO RECALL THAT THE BUDGET REFLECTS NET OUTLAYS, RATHER THAN ACTUAL PROGRAM LEVELS. THE MAJOR DIFFERENCE IS IN THE AREA OF OFFSETTING RECEIPTS, WHICH ARE CREDITED DIRECTLY AGAINST AGENCY SPENDING AND IN A SENSE COUNT AS NEGATIVE OUTLAYS.

- WHEN ADJUSTED FOR THIS FACTOR, BY REMOVING FROM THE OUTLAY ESTIMATES THE OFFSETTING RECEIPTS FOR EACH FISCAL YEAR, A SOMEWHAT DIFFERENT PATTERN EMERGES.

DISCRETIONARY SPENDING TRENDS
FY 1970-81

| | | | | Annual Growth Rates 1970-80 | |
|---|---|---|---|---|---|
| Category | 1970 | 1975 | 1981 | Current $ | Constant $ |
| Non-Defense Discretionaries[1/] | 49.1 | 85.7 | 163.5 | 11.6% | 3.3% |
| Defense[1/].................... | 75.9 | 80.5 | 146.7 | 6.2% | -2.0% |

---

[1/] Adjusted to net out offsetting receipts

- AS THESE DATA SHOW, DISCRETIONARY PROGRAM LEVELS HAVE RISEN RAPIDLY DURING THE LAST DECADE. DURING THE 70-78 PERIOD, THESE GROSS OUTLAYS ROSE AT A RATE OF 12.9 PERCENT ANNUALLY, OR 4.8 PERCENT AFTER ADJUSTING FOR INFLATION. BY CONTRAST, CONGRESSIONAL ENACTMENTS OF FY 82 AND THE ADMINISTRATION RECOMMENDATIONS FOR FY 83 PROVIDE A LONG OVERDUE CORRECTION IN THE EXCESSIVE FUNDING LEVELS THAT WERE REACHED DURING THE 1970'S.

GROSS OUTLAYS IN DISCRETIONARY PROGRAMS
Fiscal years 1981-1983
(billions of dollars)

| Category | 1981 | 1982 | 1983 |
|---|---|---|---|
| Non-Defense Discretionary Outlays | 136.7 | 130.9 | 103.5 |
| Plus Offsetting Receipts | 26.8 | 29.0 | 41.2 |
| Actual program Levels | $163.5 | $159.9 | $144.7 |

- IN NO SENSE, HOWEVER, CAN THESE REDUCTIONS BE DESCRIBED AS A MAJOR RETRENCHMENT FROM PAST COMMITMENTS. THE LEVEL OF GROSS OBLIGATIONS FOR DISCRETIONARY PROGRAMS IN THE PRESIDENT'S FY 1983 BUDGET IS THE SAME LEVEL AS PROVIDED IN FY 1979. IN REAL TERMS, AFTER ADJUSTING FOR INFLATION, THE LEVEL PROVIDED IS THE SAME AS IN FY 1976. IN ALL, THE FY 1983 PROPOSED REDUCTIONS PARE BACK ONLY 16 PERCENT OF THE EXCESSIVE GROWTH IN THESE PROGRAMS IN THE LAST 12 YEARS.

- THIS DEGREE OF RESTRAINT IS CONSISTENT WITH PROPOSED REDUCTIONS IN OTHER AREAS OF THE BUDGET. GENERAL PERCEPTIONS TO THE CONTRARY, DISCRETIONARY PROGRAMS HAVE NOT BEEN ASKED TO BEAR A DISPROPORTIONATE SHARE OF THE BURDEN OF CONTROLLING FEDERAL SPENDING. AS THE FOLLOWING TABLE SHOWS, AUTOMATIC SPENDING PROGRAMS OUTSIDE OF SOCIAL SECURITY ARE ALSO SERIOUSLY ADDRESSED IN THE PRESIDENT'S BUDGET PROPOSALS:

REDUCTIONS FROM TREND IN NON-SOCIAL SECURITY ENTITLEMENTS
(billions of dollars)

| | | | | | Annual Growth Rate | |
|---|---|---|---|---|---|---|
| | 1971 | 1981 | 1982 | 1983 | 1971-81 | 1981-83 |
| Payments for Individuals Other than Social Security | 40.5 | 151.3 | 169.7 | 179.3 | 14.1% | 8.9% |

- AS THE TABLE INDICATES, THE ADMINISTRATION'S BUDGET PROPOSALS FOR FY 1983 CALL FOR A SIGNIFICANT DECELERATION IN FY 1982-83 FROM THE GROWTH OF ENTITLEMENTS IN THE PAST. IN FACT, AS THE FOLLOWING TABLE SHOWS, THE DEGREE OF RESTRAINT IS ROUGHLY EQUAL TO THAT PROPOSED FOR DISCRETIONARY PROGRAMS:

ALTERNATIVE FISCAL YEAR 1983 LEVELS
NON-SOCIAL SECURITY ENTITLEMENTS
(BILLIONS OF DOLLARS)

| | 1982 | 1983 |
|---|---|---|
| PRESIDENT'S BUDGET LEVELS | 169.7 | 179.3 |
| LEVELS IF 14.1% GROWTH OF 71-81 HELD | 172.6 | 197.0 |
| PROPOSED SAVINGS | -2.9 | -17.7 |
| PROPOSED SAVINGS AS A PERCENT OF TREND | -2.0% | -9.0% |
| CHANGES IN DISCRETIONARY PROGRAMS FROM PREVIOUS YEAR | -2.2% | -9.5% |

o IN ADDITION, THE OVERALL RESTRAINT IN THE DISCRETIONARY SPENDING AREA IS NET OF A NUMBER OF MAJOR AREAS WHERE THE ADMINISTRATION PROPOSES CONTINUED SUPPORT AT PRESENT PROGRAM LEVELS -- OR SIGNIFICANT DISCRETIONARY PROGRAM INCREASES. FOR EXAMPLE:

-- THE BUDGET REQUEST FOR HEAD START, THE NATION'S MAJOR PRE-SCHOOL PROGRAM FOR DISADVANTAGED CHILDREN, HAS BEEN MAINTAINED AT THE $912 MILLION LEVEL -- AN INCREASE OF 12 PERCENT ABOVE THE 1981 LEVEL.

-- THE BUDGET IN KEY LAW ENFORCEMENT AREAS HAS BEEN STRENGTHENED COMPARED TO FY 82:

- FBI UP $59 MILLION, OR 8 PERCENT;

- SECRET SERVICE UP $71 MILLION, OR 32 PERCENT;

- IMMIGRATION AND NATURALIZATION SERVICE UP $96 MILLION OR BY 22 PERCENT

-- THE BUDGET FOR THE VETERANS ADMINISTRATION DEPARTMENT OF MEDICINE AND SURGERY, WHICH CARRIES OUT THE VA'S MISSION TO PROVIDE QUALITY HEALTH CARE TO VETERANS, HAS BEEN INCREASED BY 7 PERCENT, OR $500 MILLION.

-- THE BUDGET FOR THE NATIONAL INSTITUTES OF HEALTH HAS BEEN INCREASED BY $109 MILLION, OR BY 3 PERCENT.

o IN OTHER AREAS, OF COURSE, THE ADMINISTRATION IS ASKING FOR SIGNIFICANT REDUCTIONS IN PROGRAM LEVELS. YET SUCH REDUCTIONS ARE FULLY JUSTIFIED BY THE MERITS OF THE PROGRAM CHANGES BEING PROPOSED. FOR EXAMPLE:

-- THE BUDGET AUTHORITY REQUEST FOR SUBSIDIZED HOUSING WILL BE REDUCED BY $22.5 BILLION, REFLECTING A NO-NEW-COMMITMENTS POLICY UNDER THE EXISTING SECTION 8 PROGRAM. YET SUBSIDIZED HOUSING UNITS AVAILABLE TO LOW INCOME FAMILIES WILL CONTINUE TO RISE TO 3.4 MILLION IN FY 1983, AND TO 3.8 MILLION BY FY 1985.

-- THE AMOUNTS AVAILABLE FOR EMPLOYMENT AND TRAINING GRANTS WILL BE REDUCED BY $1.0 BILLION. YET THROUGH THE ELIMINATION OF TRAINING STIPENDS AND OTHER INCOME MAINTENANCE FEATURES, 392,000 ANNUAL PROGRAM SLOTS WILL BE MAINTAINED.

-- THE REQUEST FOR STUDENT FINANCIAL ASSISTANCE HAS BEEN REDUCED BY $1.55 BILLION. YET THIS GREATLY OVERSTATES THE EFFECT OF THE BUDGET ON THE ABILITY OF STUDENTS WITH NEED TO GO TO COLLEGE. PRINCIPAL GUARANTEES UNDER THE GUARANTEED STUDENT LOAN PROGRAM WILL RISE TO $10.3 BILLION. THUS, IN 1983, THE BUDGET PROVIDES A TOTAL LEVEL OF TUITION SUPPORT OF $12.1 BILLION, NEARLY THREE TIMES THE LEVEL AVAILABLE IN 1977.

-- ENERGY PROGRAMS HAVE BEEN REDUCED BY $759 MILLION, OR BY 29 PERCENT. YET THESE PROGRAMS PRIMARILY SUBSIDIZE COMMERCIAL DEVELOPMENTS WHICH, IF VIABLE, CAN AND WILL BE DONE IN THE PRIVATE SECTOR.

-- COMBINED FUNDING FOR THE WIC PROGRAM AND THE MATERNAL AND CHILD HEALTH BLOCK GRANT WILL BE REDUCED FROM THE COMBINED FY 1982 LEVEL BY $282 MILLION. YET THE $1.0 BILLION REQUEST FOR THESE PROGRAMS IS TWO-THIRDS HIGHER THAN THE COMBINED $600 MILLION PROVIDED IN THESE AREAS IN FY 1977.

## THE ECONOMY AND SMALL BUSINESS

Chairman HATFIELD. Mr. Stockman, I have many questions but I will restrict myself to 5 minutes here so everyone else can have some opportunity as well.

Mr. Stockman, could you comment on the general economic picture as it relates to the future of small businesses and small enterprises under this present economic game plan?

I know that in budget authority we have a proposed increase of $43.4 billion for the military in fiscal 1983. We will have increased in this administration since it has held office $115 billion in military spending, which is larger than the projected deficit for 1983.

As I see this kind of escalation, and the impact it has on the capital, or the lack of capital available in the civilian sector of our economy, especially in smaller enterprise, it seems to me between that lack of capital and the cannibalism that is practiced within many of our corporate fields today, we are in the process of sovietizing our economy. We are imposing upon this economy a $1.6 trillion demand in the next 5 years to produce goods and services, and that demand is being met by military spending policies as outlined here in this fiscal year 1983 budget and fiscal years 1984 and 1985.

It seems to me that the job-producing segment of our economy and the meeting of the capital needs for the small enterprises are going to be continually frustrated.

So I want to know, what can we say to the American businessman, not the giant corporations which have enough capital to buy Conoco or Dean Witter and Company; they don't have to worry about capital or credit. What about the small enterprises that are increasing in bankruptcy in my State at such a staggering rate we can't keep track of it. The housing market is so deeply committed and related to our timber-based economy, it is staggering. I know this is true with the small farmers, in the Midwest, and small business throughout the country. Everywhere I travel I find there is absolutely no hope that the small businessman has in this economic program as it relates to him.

What do you say to that small businessman? After all, I think that the fusion of economic power is as important as fusion of political factors. I applaud the new federalism concept of a decentralization of political power but it has to be accompanied by decentralization of economic power. I think the concentration of big power in business and Government and labor leads to fascism; that is the direction we're going in. Unless we do something radical at this time to reverse these trends, there will be no such thing left as the independent sector of our timber industry in the next 5 years under this economic program.

And I can tell you that that will be true with a lot of independent sectors, small business enterprises in other parts of the country.

How is this going to correct that trend, this trend of sovietizing, as I call it, the economy.

### IMPACT OF DEFENSE SPENDING

Mr. STOCKMAN. Mr. Chairman, let me make a number of points. I am not sure that I would charactertize developments in the same way. On the matter of defense, I understand your views, but I think that the current deficit cannot be blamed on defense. To the extent that the deficit contributes to the higher interest rates and therefore punishes the small business sector, it is important to the financial markets to reduce the deficit as a whole, not any particular category of Government spending.

As I indicated, we have increased obligational authority by $115 billion between the 1981 budget and 1983, but that will take a long time to spend. It will take a long time for those orders to go out and be delivered. The impact on the economy will be spread over the same period of time. In terms of outlays, the increase is only $45 billion in 1983 and that is difficult under the fiscal circumstances that we are facing today, but it is not nearly of the magnitude of the TOA increases that we have had to request.

The second point I would make is that defense will impose strains and burdens on the economy in particular sectors as the level of procurement rises. We also have to recognize that $1.6 trillion is a big number, but it is only 7 percent of the economy over the 5-year period in which it is going to occur. In many periods in the past, we have spent more of the share of GNP on defense—9 or 10 percent in the 1940's, 1950's and 1960's. This was compatible with the healthy economy and, in fact, was compatible with health for small business.

I don't think the problem is defense per se. As an economic matter, it is a policy issue of priorities and what you think we need to spend to meet our national security objectives. There are great differences of opinion that will be thrashed out, I am sure, during this session of Congress.

### HELP FOR SMALL BUSINESS

On small business, my view is that there is no program that will relieve the distress of small business at the present time simply by passing an appropriation or an act. I will note that last year there were 14 million small businesses in the country, many of them in the circumstances that you have described, and we made 20,000 loan guarantees and 4,000 direct loans. We can't solve the problem that way. The only way we can solve the problem is with a fiscal and monetary policy that will bring the interest rate down. I think we had some problems with monetary policy in the last 3 or 4 months but it looks to me like it is getting on track. It looks to me like they are easing in money market as indicated by the 270 basis point fall in the T-bill just in the last 3 trading days and we can expect that easing will continue over the spring. It doesn't solve the problem but it begins to reverse the direction.

The unaddressed link in this whole equation in terms of getting the interest rate down enough to relieve small business and get the economy moving forward is the fiscal problem. If we cannot demonstrate to the financial markets, to investors, borrowers, and businessmen that we have a plan to reduce these $150 billion deficits in 1983 and 1984 as the economy is scheduled for recovery, then I believe it will be difficult to get the recovery. I believe it will be difficult to get the interest rate down and I believe there will be very little we can do to relieve the distress in the small business sector and to reverse some of the trends that you and others are concerned about.

So it seems to me the action is on the budget, on the fiscal issue and the desperate need to put together a plan jointly between the Congress and the administration that preserves the important objectives that we have, but closes the deficit dramatically in order that these interest rates may come down and the recovery move forward.

Chairman HATFIELD. There is a procedure that I have to follow because there are many other following comments. My red light is on. I will defer to Senator Stennis.

Senator STENNIS. Mr. Chairman, I want to respond in kind and be brief.

### ENTITLEMENT REFORM

Mr. Stockman, I think all of us owe you a lot for the work you have done last year and this year. You gave all your tax goodies last year and that is a bill to pay. This year when you get the hard ones again with entitlements, why didn't you go into that and do some of the hard things on entitlements this year?

I know you have this study underway, but some things are so obvious that you've got to make some adjustments. We are going to get down to the hard figures mighty fast, I think, this time. We have this military program and we have to make a judgment there, then make a judgment whether we are going into entitlements and so forth, mighty fast. Why didn't you tackle those entitlements if, as you say, in effect we won't get out of the hole until we do? I think you are right. If we get out and not do anything about entitlement problems, we go right back into another situation in a few years, I would think.

Why don't you just take part of it this year?

Mr. STOCKMAN. Mr. Stennis, I think I would answer that question by pointing out there are two aspects of entitlements: first, the indexed program and the cost-of-living adjustment which is very expensive and which we have not addressed across the board, but we have addressed in military and civilian retirement; and, second, the structure of benefits, eligibility, and reimbursement provisions for medicare and medicaid and so forth.

We have addressed the latter part and we have 12 billion dollars' worth of savings in the budget for 1983 and $52 billion over the next 3 years on entitlements in the area of eligibility, benefits, medical reimbursement rates, cost-of-living adjustment for military and civilian, and so forth.

In the area of cost-of-living adjustments, I remember well that last year the President proposed what he thought was a fair, balanced, and workable program to solve the social security crisis that would have reduced the cost of COLA adjustment in that program by moving the date to October at a savings of $4 or $5 billion a year.

Unfortunately, that proposal was not seriously considered and evaluated. It was simply rejected and turned into a political football and a campaign device on the part of those who were more interested in looking for political points than in solving the problem.

I think our view at the present time is that if we are going to solve this budget problem, one area that we are going to have to have a solution for is these index programs. But if we are going to have that solution, it is not for want of a blueprint—everyone knows what to do—it is for want of a bipartisan consensus. I would hope in the next several weeks or months as we grapple with this 1983 budget problem that we see the emergence of a bipartisan consensus on this issue so that some contribution to reducing the deficit can be achieved in the area that you have just described.

### SOCIAL SECURITY

Senator STENNIS. On the social security proposal you made some recommendations that I voted with you on, but later it was abandoned. I don't think you ought to call that political any more than the administration itself is political.

Here we are back again, and we don't have anything very helpful from you on that.

About social security, would you favor taking it out altogether from the budget, the Social Security Act, and accept that money doesn't belong to the Treasury and so forth? Do you have a plan to take it out of the budget?

Mr. STOCKMAN. Mr. Stennis, I don't believe to do that would be wise. The decision was made in the 1960's, by those who were knowledgeable in both the executive and legislative branches at that time, that it should be part of the unified budget. Simply removing it from the unified budget totals would have no effect on anything other than accounting and require two sets of books.

Senator STENNIS. I can't agree with that. It is a different type of money. It is paid on different circumstances. It doesn't really belong to the Federal treasury. It is a trust fund for the benefit of those who paid into it. Something ought to have been done. That is undermining the confidence of the people in the Government more than any single thing, as I see them and talk to them and see them at the crossroads, out where they live and where they struggle to get that money they paid.

I think if we don't restore that confidence in that fund we are taking a dangerous risk.

Anyway, we got to do something this year, you say, on this budget.

### MILITARY SPENDING LEVELS

Did you have anything to do with setting these military figures on your own? Do they represent your figures or whose figures if not yours?

Mr. STOCKMAN. Mr. Stennis, I have a little experience but it pales in comparison to yours. I think from long experience you know that the budget process is complicated and that many hands participate and many views are melded.

My views were heard and I fully support every aspect of this budget as every budget director does.

Senator STENNIS. I know you support it. I am not cutting you off.

My question was, did you really take a part in the judgment process that went into these figures that are now what we called the military budget.

Mr. STOCKMAN. Yes, I did.

Senator STENNIS. To what extent? Appreciably or not?

Mr. STOCKMAN. To the appropriate extent.

Senator STENNIS. The appropriate amount, that is not going to help us much when we get down to the conference here to try to adjust these figures. If you took part in it or if you didn't take part in it, I think you ought to tell us. I mean a direct contribution.

Mr. STOCKMAN. Mr. Stennis, I made a direct contribution throughout the last year, as you well know. I know that there is a great deal of controversy about the size of the buildup and the numbers, but you also know that some of those who were talking about huge reductions in defense simply do not have a great degree of knowledge about what is practical and feasible at the present time.

Senator STENNIS. I am not trying to trap you, of course. My time is up.

Thank you, very much, for those helpful answers.

Chairman HATFIELD. Senator D'Amato?

### A TEST OF REASONABLENESS

Senator D'AMATO. Mr. Stockman, I hope you will be candid today, particularly to someone who has given overwhelming support to the kinds of budget cuts that were proposed and enacted last year, especially if you look forward to eliciting my support for this budget document.

I find this budget document appalling. I think it is built on quicksand. We are not talking about a $91.5 billion deficit. We are talking about a deficit that can go as high as $140 billion.

I would like to know what test of reasonableness was used when revenues and expenditures, were projected?

Wall Street isn't responding and the investment community isn't responding and interest rates aren't coming down because they see much more substantial deficits than what is projected in this document.

You are wrong if you attempt to deal with the deficits by cutting guaranteed student loans to those who are graduate students and when you begin to tinker around with what the formula will be for mass transit.

This is not addressing the real problem. The real problem is entitlements.

Where is your candor? I agree that we have to reduce these deficits, but lets do it in a meaningful way. Why not consider a bipartisan approach? I want to tell you there are people I speak with who say, "let's get together in a bipartisan manner." I wish this had happened last year and, although it did not, I hope it is not prevented from happening this year.

## OFFSHORE OIL LEASES

Let me look at one area, offshore leases. Do you predict $18 billion for 1983 in revenues?

Mr. STOCKMAN. That is correct.

Senator D'AMATO. What was predicted for this year, 1982?

Mr. STOCKMAN. Senator, let me answer that because there is an accounting anomaly between the 2 years that needs to be understood.

In 1981, we had about $10 billion. In 1982, we have a much bigger leasing program. However, $2.9 billion of the receipts that we expect in 1982 will occur in the last month of 1982, so they will actually be paid into the budget in 1983. They drive up the 1983 number as they drive down the 1982 number.

Second, during 1982, we expect that about $2.4 billion in offshore receipts will be held in escrow pending the outcome of litigation that should be solved by 1982.

If you make those adjustments, instead of a $7.8 to $18 billion difference, you are basically looking at $12 billion in 1982 and about $16 billion in 1983.

A much smaller increase has to do with timing of when the receipts are counted as they come in the budget.

Is it reasonable to have a $4 billion increase in 1 year?

I think absolutely. In 1983, we will lease acreages which have an oil potential of 28 billion barrels compared to acreages which have oil potential of 4 billion barrels in 1982.

Second, the acreages that we are leasing in 1983 have an estimated average value per barrel of $5 and some cents, compared to $2.80 in 1982.

When you put those kinds of factors together, there is more to the story than simply the anomalous appearance of these numbers from one year to the next.

I believe we can't be sure about these receipts on the margin because you have litigation and you don't know exactly what companies are going to bid. I can only say that since we have been in office, the bids have come in, on the average, higher than we have projected rather than lower and that if you make these accounting adjustments that I just mentioned, the number is not nearly as incredible as some will have you believe.

## REVENUES FROM OFFSHORE OIL LEASES

Senator D'AMATO. Now that we are almost halfway through fiscal 1982, what has actually been raised in revenues in fiscal 1982 from offshore oil leases?

Mr. STOCKMAN. Senator, I would have to supply that for the record.

[The information follows:]

The attached tables show the OCS funds for 1982 depostied in budget receipts accounts through January. They also show the 1983 budget's estimates of receipts for February through September. The actuals are running ahead of the budget's estimates by $148 million for rents and bonuses and are running behind by $20 million for royalties.

OCS FUNDS DEPOSITED IN TREASURY BUDGET ACCOUNTS

[In millions of dollars]

| | Rents and bonuses | Royalties | Totals |
|---|---|---|---|
| October | 5 | 242 | 247 |
| November | 894 | 334 | 1,228 |
| December | 264 | 95 | 359 |
| January | 260 | 223 | 483 |
| Totals | 1,423 | 894 | 2,317 |
| Budget plan for remainder of the year: | | | |
| February | 133 | 265 | 398 |
| March | 1,109 | 265 | 1,374 |
| April | 79 | 242 | 321 |
| May | | 265 | 265 |
| June | 79 | 266 | 345 |
| July | 315 | 242 | 557 |
| August | 274 | 265 | 539 |
| September | 1,607 | 266 | 1,873 |
| Totals | 3,596 | 2,076 | 5,672 |
| Comparison of budget plan and actuals: | | | |
| 1983 budget's total for fiscal year 1982 | 4,871 | 2,990 | 7,861 |
| Budget plan for February through September | 3,596 | 2,076 | 5,672 |
| Budget plan for October through January | 1,275 | 914 | 2,189 |
| Actual deposits October through January | 1,423 | 894 | 2,317 |
| Actual deposits minus budget plan, October through January | 148 | -20 | 128 |

## CREDIBILITY OF PROJECTIONS

Senator D'AMATO. I think that will be an interesting analysis. It might show that we are lagging substantially behind what was projected for 1982 and that would throw substantially out of kilter the projections for 1983.

My point is that when we begin to misestimate by billions of dollars, either revenues or expenditures, then the lack of credibility in the budget document is reflected in exactly what is taking place today in the long-term bond market.

If you were an investment counselor and you saw these hefty budget deficit projections, and I am not going to quibble over estimates, that might go $10 billion one way or the other, you wouldn't be giving advice to your people, to your clients, to get into the long-term bond market.

Municipalities will continue rolling over obligations, borrowing short term. Those in need of long-term financing will continue to find it most difficult to obtain and will be forced to borrow short term. This harms not only State and local governments, but also destroys the construction industry.

Do you know why the inflation rate is coming down?

I would like to know how much you attribute to the recession that we have and to the business activity that has dropped off?

We better begin to recognize that it is not a good enough slogan to say, "let's cut the deficits." Let's do it in a bipartisan way.

Although I have a number of other questions and observations to make, I realize that time is short.

Mr. Chairman, I thank you and I hope I will have an opportunity to submit some written questions for the record.

Chairman HATFIELD. We may submit written questions to follow up these hearings, Mr. Stockman. Senator Byrd?

### BIPARTISAN SUPPORT

Senator BYRD. Mr. Stockman, I am very intrigued by your appeal now for bipartisan support and bipartisan effort in dealing with the problems that confront us.

I note in the Atlantic Monthly, page 35, the following statement: "In early February, preparing the political grounds, Stockman started delivering his black book to Republican leaders and committee chairmen."

On a later page, "In the early skirmishing on Capitol Hill, Stockman actually proposed a tight control system."

Those are two examples of the kind of bipartisanship that was being practiced in those days.

We, on our side of the aisle, sought to offer alternative proposals from time to time last year, only to have them defeated without any apparent consideration of the merits of the proposal.

We sought to tie the third year of the tax cut to the performance of the economy, a proposal which I made to President Reagan during a meeting at the White House; and we were beaten, as we were beaten down on all other alternatives that we offered.

So now we come to the point when even our friends on the other side of the aisle are having second thoughts about the Kemp-Roth proposal. The President, in drawing that line in the dirt, has pretty much isolated himself. A good many Republicans are agreeing with Democrats, and some of the foremost economists and many people in the financial community on the other side of the line in the dirt are trying to find a way that will reduce the damages that are being done by the Kemp-Roth proposal which was rammed down the throats of the Congress without any thought of bipartisanship. These damages had most of us concerned at the time.

We on this side of the aisle have continued to demonstrate our desire to work in a bipartisan way and we will continue to do so.

We are at the present time developing some alternatives that might be helpful to the American people as we attempt to deal with the colosal budget deficits that loom down the road, and the continuing high interest rates, the continuing record of bankruptcies, high unemployment, and the recession.

So we will not turn deaf ears to the appeal of bipartisanship even though their appeal comes at the 11th hour.

I find it somewhat interesting, however, that you indicate there is a necessity for it.

### UNEMPLOYMENT

In West Virginia, we have severe unemployment in the Weirton steel plant which has furloughed 25 percent of its work force. Elsewhere in the State, such as at the Kaiser plant in Jackson County and the Corning Glass Works in Martinsburg, many workers have been furloughed or lost their jobs because of the present economic downturn.

The hoped for economic recovery in the fall is a long way off for these people.

Let me add that I am talking about people who don't want a handout, people who want a job, people who want to work. If the ecomomic conditions are such that work is not available at the present time, how does the fiscal year 1983 budget assist these unemployed workers during the present economic transition?

Mr. Stockman. Senator, let me respond to that question and some other points you made. I appreciate your perspective on it, but I do remember during the same February period that you cited that, upon my request and your invitation, I met for more than 2 hours with Members of the minority caucus of the Senate to explain the entire economic program and the budget proposals and to receive some input and advice as to where some modifications could be made.

Obviously, we didn't accept all of the suggestions but we did consider all of the suggestions. I do know that the minority Members from the State of West Virginia felt very strongly that we couldn't abruptly terminate the Appalachian Regional Commission and the EDA program in 1 year. As a result of those feelings that were expressed, as well as others, we agreed to funding for those programs in the 1982 budget in order to give some time for transition in these areas. I think I would have to disagree a little with you on the notion there wasn't any effort last year.

### LIMIT ON THE DEFICIT

I also want to clarify something because in this political debate, and I recognize the pressure, the differences of opinion, and how things can build up, there is a metaphor that emerged from a speech that the President gave that has been totally misunderstood. It has been given a kind of provocative abrasive connotation that was never intended.

He said "I am drawing a line in the dirt." What he was referring to was the deficit numbers of $92 billion in 1983, $83 billion in 1984, and $72 billion in 1985.

What he was saying in that speech, if you read it carefully, is simply that we dare not permit the deficit to go one dime above that level. If Congress can come up with ways to go below it, so much the better if we expect the economic recovery to go forward. That is the answer to your question.

If we can work together to insure the deficit doesn't reach that line, the maximum that we can tolerate, and we can get unemployment lower than I believe the rate you have referred to in your State and Chairman Hatfield has referred to in his State, and elsewhere, then those people do have good prospects that their jobs will return and that economic prosperity will recover, beginning later this year and on into the future.

Chairman HATFIELD. Thank you, Senator Byrd.

Senator Mattingly?

Senator MATTINGLY. Thank you, Mr. Chairman.

One thing I found out when I was home, Dave, is that the people are tired of criticism and everybody being negative and everybody being cynical. I feel that there is some good news out of all this, although in the last few weeks, if you read the newspaper, you probably wouldn't think so.

I think of what has happened and I join my colleagues on both sides.

Now, we see a lot of creativity coming out. When you get past some of the smoke of some of the criticism and negative comments that are made, I think you are going to see a joining together now with a new proposal and I am not saying which proposal I embrace. I know one proposal that I do not embrace and that is to increase the taxes upon the people of our country. And when we keep referring to comments made like Kemp-Roth damage that was done, I think that maybe sone people should go look and see what the increase in taxes is going to be beginning this January 1st.

I think if I am not mistaken, the tax burden is going to go up on the individual taxpayer counting social security of $22 billion.

When we go looking trying to help people I don't think what we need to do is load up the American people again with more taxes because I think we can go back historically in our country, and I think a few years prior to me coming into the Senate, and see what increased taxes did and what happened to the deficit at those times. And I would ask the same question.

### ENTITLEMENT REFORM

I was talking to Murray Weidenbaum and the consensus that I see developing from both sides is something that has to be done on the entitlement programs.

There is no way we will ever balance this budget until such time we are willing to take on the entitlement program.

What I will ask you is, is the administration, not that it makes that much difference, I guess, willing to take on these entitlements, or do they want us to go ahead and take it on for him and present it to him?

Mr. STOCKMAN. Senator, I am not sure that the process would be that simple. We have proposed to take on entitlements, and, again, I make the point I made before, there is more to entitlements than the index cost-of-living adjustments, although that is part of it. I have noted in recent days that a number of people from both sides of the aisle have proposed we look at the indexing issue and I think as this proposal unfolds, we may well come to some consensus about that.

At this point in time we recommend our budget because it does address entitlements in other ways to the tune of $52 billion over the next 3 years.

Senator MATTINGLY. When we pass it, you will accept it.

### ASSET SALES

One other question: Have you considered the selling of assets? Do you consider that a real positive thing that can be done in our country to help get down the deficit?

Mr. STOCKMAN. Yes; I think it would be helpful, and, yes, we proposed it in the budget. We expect to realize about $4 billion a year beginning in 1984 through the disposition of surplus real property and land.

I would just note that at the present time, for instance, the Federal Government owns 400,000 buildings and 2 billion square feet of building space. We obviously don't need all that. Some of it is being underutilized. Some of it is located in very high priced real estate areas where operations could be moved and the land could be sold.

We have an uncoordinated mechanism in the executive branch for managing the huge property holdings of the Federal Government. For that reason we have instituted a property review board. An aggressive comprehensive effort will be made to sell assets that we don't need.

At the same time, I will underscore that we are not talking here about the the national parks or the mutual purpose use national forest or the wilderness areas or refugees or anything like that, but the massive GSA holdings. Some of the unnecessary holdings in the public lands area will be reviewed and considered for sale if the case warrants it.

Senator MATTINGLY. The S. 231 offered by Senator Percy?

Mr. STOCKMAN. Yes; in fact, I will be testifying to that tomorrow.

Senator MATTINGLY. If that happens, taxable properties revert back to cities.

Mr. STOCKMAN. In many cases, especially where you would be selling land that is near developed areas that has high real estate value, it would have a substantial and favorable impact on local tax base.

I would underscore this is in the budget already—the $4 billion—and that helps us to get to the $92 billion deficit, 1983 and so forth. It doesn't lower it beyond what we have projected now.

Senator MATTINGLY. Is there any reason why it couldn't be accelerated?

Mr. STOCKMAN. Perhaps. As I look at it, I think we are stretching the limits of what is practicable, given the complexities involved and the balancing issues involved.

I don't think it would be prudent for anyone to think that at least for the next several years, more than $4 billion is possible by way of realizations from property and other assets sale.

Senator MATTINGLY. Unless we find a better way to accelerate it.

Chairman HATFIELD. Thank you, Senator Mattingly.

Senator Eagleton?

Senator EAGLETON. I wish to dissent in part from Senator Mattingly on all this lovely bipartisan get-together consensus, et cetera.

I agreed earlier with Senator Garn, we have to look at entitlements, so I don't dissent in that part, but I believe we have got to do something on the revenue side and not only do I believe it, the administration believes it and Mr. Weidenbaum one-half hour ago made the same point we have got to do something on the revenue side and the administration is recommending $34 billion in revenue recapture. I say that is a pittance.

I am glad at least they are heading in that direction.

My question to you, Mr. Stockman, not to haunt you with the Atlantic article— you committed that mortal sin and you have done a mea culpa over it, but to make the point on the revenue side, the one I like best out of the article, "Do you realize the greed that came to the forefront, the hogs were really feeding, the greed level, the level of opportunism just got out of control."

You couldn't have said it better.

### THE ECONOMIC RECOVERY TAX ACT OF 1981

Mr. Stockman, the greed level on that bill, as you said, the unholy bidding war, the giveaway war that was entered into by the President of the United States and the chairman of the House Ways and Means Committee, was unbelievable. One tried to top the other on how much of the Federal treasury they could give away. The result was the President's basic economic proposals which had only two parts to it on February 18—the 10 and 10 and also accelerated depreciation—got bloated with the addition of marriage penalty, indexing, charitable contributions, foreign earned income, business tax cut provisions, royalty credit and exemption, reduced tax for new oil, other energy provisions, all-savers, estate, miscellaneous, race horses and the Charlie Walker midnight special, Hertz rent-a-tax provision. Now that bill is tabulated up in the billions, so when we ask the Treasury Department for a revenue loss estimate, they won't give us any more because it keeps ticking up every day.

Occidental Petroleum, poor little Occidental, sells its tax loss. Burlington Northern, the most prosperous railroad in the country, sells its tax losses.

The 1981 tax bill was a bloody monstrous disgrace and you know it.

You said in your article, "So if we are qoing to do something about balancing these budgets, then we are all in lock step together," and that was in the 1981 Republican platform just as much as Kemp-Roth was in there.

If you really want to live up to the 1980 Republican platform, if you really want some bipartisan balancing the budget, let's do something meaningful on the revenue side. Let's capture back $250 or $300 billion of that egregious $750 billion giveaway.

Now, don't you think that the words I quoted from your article about the greed and the level of opportunism, don't you think they apply just as much today as in November when you were quoted in that article?

Mr. STOCKMAN. I think they do but I think you can carry it too far. Obviously, in the final days of consideration of that bill, all kinds of things were added that didn't necessarily constitute sound public policy and that under the circumstances weren't needed or justified.

But I think you should not underestimate how cheaply the hogs sold out the revenue impact. Some of the measures that I was referring to are relatively miniscule compared to the size of the tax reduction and I hope we don't lose sight of that. Sone of these provisions that you have named make up a relatively small share of that $750 billion.

Senator EAGLETON. When Charlie Walker made the night special what was your price tag? What do you give as a 5-year estimated cost of the Charlie Walker midnight special tax law?

Mr. STOCKMAN. I am not sure the precise number. What we have in the budget I believe is somewhere in the $28 billion range over a 5-year period of time.

Senator EAGLETON. Twenty-eight billion dollars and going up.

Do you as the spokesman for the administration fervently believe in the necessity of keeping that provision in the Internal Revenue Code?

Mr. STOCKMAN. Let me explain why I think it is there.

Senator EAGLETON. Do you as the spokesman for the administration fervently believe in the continuation of that ripoff in the Internal Revenue Code?

Mr. STOCKMAN. If you are going to have a 5-year rate of equipment and machinery in order to stimulate investment in jobs, then you need something like leasing or its functional equivalent or the 5 year value will be no value.

Senator EAGLETON. Does Occidental Petroleum need that kind of gimmick to survive?

Mr. STOCKMAN. It is not a matter of——

Senator EAGLETON. Does Anheiser-Busch, need that in order to survive?

Mr. STOCKMAN. The provision is not designed to help companies survive. It is designed as a deliberate tax incentive.

Senator EAGLETON. Designed to allow some greedy companies to have even greedier returns.

All those three companies that I just mentioned have been fabulously successful., fabulously profitable.

### ACCELERATED DEPRECIATION FOR CAPITAL INVESTMENT

Mr. STOCKMAN. I understand your concern about that and a lot of other provisions of the bill. If you give me 1 minute, I would like to make the point that the tax break for capital investment—that almost everybody supported regardless of their view on Kemp-Roth—was in the nature not of a rate deduction, not of a tax credit but of an acceleration in time of the period that you could write off the depreciation.

That has a present value that is larger and larger, the shorter the time you can write it off.

That was the nature of the ADRS that everybody supported. Once you decide that is what you want to do to stimulate capital investment not as new tax credit, not a lower corporate rate, but an acceleration of the tax writeup period, then you must have a way for companies that are small and just starting or that are unprovable for a period of time to take advantage of it because there is no tax incentive unless you can take advantage of the acceleration now. If you wait 2, 3, 4 years, there is no tax advantage, no incentive, no stimulus.

I think your argument is with the accelerated depreciation and not with the leasing.

If you think too much was done in that area or that a better approach to stimulating investment in job creation is warranted, look at both of them together; but you can't separate the two because the leasing is necessary to take advantage of the acceleration for a good share of the companies in the economy.

Senator EAGLETON. If there is no relief on the revenue side, as far as I am concerned, there would be no bipartisan effort on the other facets of the budget.

If this administration is going to say that 1981 tax bill is immune to any change whatsoever, then don't look to me for any great bipartisan support.

Chairman HATFIELD. Senator Leahy?

### THE PRESIDENT SIGNS THE BILLS INTO LAW

Senator LEAHY. I should point out, Mr. Stockman, that before you express the belief that the Congress attempted to ramrod any kind of tax provisions down the administration's throat, you should consider President Reagan's statement that if he doesn't approve of the bill when it reaches his desk, then he will veto it. He stated that if the revenues don't match exactly what he wants, then he will veto them. He even went into a PR person's dream of closing down the Government, and installing recorded tape messages. This is by far the tackiest thing that has been done at the White House. I can just see them in the kitchen washing dishes, and saying that we must close it down for $1 or $2 billion on the overall budget of over $700 billion. So don't ever get the impression that somehow things were forced down your throat. There wasn't anything in that bill that the White House and you didn't approve of.

Senator Eagleton has brought up the point of Burlington Northern tax benefits. The tax breaks for that one company, a very profitable company, will be more money in the next 5 years than this tax cut will give every single person in the State of Vermont.

I will not refer to quotes in the Atlantic Monthly. I was one of the few people up here who stood up and applauded you at the time of that article and said you ought to get a gold medal for telling the truth, instead of jumping all over you as many others did.

### INDEXING OF ENTITLEMENTS

There have been suggestions that indexing of entitlements should be restricted or ended. How do you feel about that?

Mr. STOCKMAN. I think that is one thing we are going to look at. We are not recommending it in this budget. I think everybody realizes that the inflation rate is falling rapidly now. Therefore, the pressure on cost of living for people receiving benefits is not as great. Also, the CPI has been overmeshing the inflation rate for some time and, therefore, some adjustment is warranted.

Senator LEAHY. What is your personal feeling?

Mr. STOCKMAN. My personal feeling is that I would like to see a consensus emerge in Congress to do something across the board on the indexing issue, but it is going to have to be done in a bipartisan basis or it can't happen.

Senator LEAHY. But we are all dealing with an administration that is, of the three administrations I am familiar with, by far the most partisan in its approach on these budget matters.

Mr. STOCKMAN. I can tell you this: there would be no disposition and no desire on the part of this administration to take advantage of the issue if those in your party and elsewhere in the Congress decided it was time to take action. I can assure you of that.

Senator LEAHY. However, this thing is going to require some Presidential leadership because you do have a majority in the Senate. Not much is going to be done without Presidential leadership.

How do you feel about the indexing of the tax code enacted last year; a good idea or a bad idea?

Mr. STOCKMAN. Basically, I think it is a good idea.

Senator LEAHY. You don't think there should be any changes made in that indexing?

Mr. STOCKMAN. I think if Congress wants more revenues, we ought to consider how much and where to derive them.

Senator LEAHY. I am asking your opinion as the Director of OMB. I am asking your opinion now, would you not make any changes in the indexing of the tax code?

Mr. STOCKMAN. That is correct.

Senator LEAHY. But you would make changes in the indexing of entitlements?

Mr. STOCKMAN. I am suggesting that is something we will want to look at.

Senator LEAHY. When you say we may want to look at it, you can also look at what the weather is like when you go outside, but that doesn't have a lot of effect on what might happen in the economy over the rest of the year.

You can look at a lot of things. But if you look at it with the idea that you might want to make some changes in it——

Mr. STOCKMAN. I know what you are driving at.

Senator LEAHY. Tell me what I am driving at.

Mr. STOCKMAN. I think you are suggesting there ought to be parallel treatment. What I am suggesting is that we are perhaps over-indexed for the latter part of the decade on the benefit side and we have not indexed at all on the tax side. We need to have equilibrium between the two.

Senator LEAHY. You would make changes in the indexing of entitlements, but not of taxes?

Mr. STOCKMAN. We have proposed changes in this budget, changes for an indexing mechanism for a variety of things including putting a cap on the civil service and military cost-of-living adjustment below the CPI.

### IMPACT OF EPA BUDGET CUTS

Senator LEAHY. Let me ask you a hypothetical question.

If one were a Governor of a State and he found out that the number of automobiles on his State's highway was going to double in the coming year, would it necessarily be wise for him to cut the highway patrol in half?

Mr. STOCKMAN. Probably not.

Senator LEAHY. In the next 10 years, I understand that all our projections show that air pollution is going to increase by 50 percent if it is not controlled. EPA is required a change to the permits of 90,000 polluters to require them to install a system to reduce 50 million tons of hazardous waste each year.

Your proposed budget cuts the EPA budget nearly 40 percent compared to the last Carter budget. Isn't this a back door way of repealing the Nation's environmental laws through the budget process?

Mr. STOCKMAN. No; I don't think so. We can argue long and hard about the precise resources you need where and what to do.

I would say the biggest cut in EPA has been in the research and reports funds. The research and reports were piling up in the shelves and not being used. The contractors were ripping off the system. We felt it was desirable to cutback substantially in that area. We felt EPA was overstaffed. It has grown from 7,000 people when they started to 14,000 on board when we came in and that wasn't necessary. So we made reductions in personnel and payroll to save money.

But in terms of getting the enforcement job done, I believe the resources that are there are adequate. By turning more of the burden over to States, I think we will get more compliance than enforcement.

I remember well, and you probably do, too, in the latter year of the previous administration, EPA was overseeing and second-guessing practically every decision made by a State office that under our scheme actually has responsibility for implementing the clean air and the clean water enforcement program. Sure, there needs to be monitoring—but not second-guessing on every decision, every permit, every case that comes before the State agencies. Those are some of the things that we have tried to change that do justify a reduced level of resources.

Senator LEAHY. I would like to read into the record, the Director of the Office of Water Regulations recently stated in a sworn affidavit that EPA could not comply with the law because "The number of personnel and budget allocated to the programs being reduced."

Mr. Stockman, what you are trying to do is to change the environmental laws by cutting back the money in EPA. I must admit from the hearings I have sat on here, I come to that conclusion too.

Chairman HATFIELD. Senator DeConcini?

### PROTEST OF BUDGET INCREASES

Senator DECONCINI. Mr. Stockman, in the years when programs for the poor and elderly, and the disadvantaged children of this country are being slashed or abolished altogether in fiscal 1983, it is, in my opinion, an absolute outrage that the President, you, and Secretary Regan are on Congress' doorstep asking for large percentage increases in your staff budgets. The White House Office is requesting a 17-percent increase next year—from $18,877,000 to $22,164,000 in 1983.

The Office of the Secretary of the Treasury budget would jump by 13 percent from $52,971,000 to $59,752,000 next year. Your own OMB budget would be boosted by 13 percent from $32,079,000 to $36,109,000 in 1983.

To add insult to injury, the Secretary of the Treasury is requesting $95,000 in his office budget for so-called official reception and representation expenses—$35,000 more than the Vice President receives for such activities. As we all know, that money goes for alcoholic beverages, hors d'oevres, and other party items at official gatherings. The average American taxpayer would pay taxes for over 25 years just to cover the cost of the Secretary's reception budget for 1 year.

What I would like to know, Mr. Stockman, is what would be the effect on White House Office, OMB, and Office of the Secretary operations in fiscal 1983 if this committee were to keep your 1983 budget at the current 1982 level contained in the continuing resolution? Frankly, that is exactly what I intend to recommend to the Treasury Appropriations Subcommittee, where I am the ranking minority member.

[The information follows:]

### THIRTEEN PERCENT INCREASE IN THE OFFICE OF THE SECRETARY OF THE TREASURY

The apparent 13-percent increase between fiscal years 1982 and 1983 is somewhat distorted because the fiscal year 1983 figure of $59.7 million includes $3.1 million for the effect of the October 1, 1981, pay raise and lifting of the pay cap. The fiscal year 1982 figure does not include the pay supplemental request of $2.8 million which is still pending aproval. If both years reflected the effect of the pay raise and pay cap, the increase would be 7 percent, certainly within the normal limits of today's inflation rates.

### HOLDING FISCAL YEAR 1983 AT THE FISCAL YEAR 1982 CONTINUING RESOLUTION LEVEL

If the Office of the Secretary of the Treasury were to be appropriated funds in fiscal year 1983 at the same level allowed under the fiscal year 1982 continuing resolution, it would have a dramatic effect on the mission of the Department. In fiscal year 1982, the Department's cost-savings plans include reducing as many support-type functions as possible, reducing contracts, rationalizing functions and outplacing approximately 100 personnel in an effort to avoid major RIF's and furloughs. The fiscal year 1982 cost-saving measures have been taken as interim steps in the hopes of having part of these reductions funded in fiscal year 1983. The fiscal year 1982 level of operations, maintenance, and administrative costs cannot be pared down any more; deeper cuts into organizations and mission responsibilities would have to be made at the expense of national and international tax and economic policy operations.

### REPRESENTATION REQUEST OF $95,000

In fiscal year 1983, the Office of the Secretary, salaries and expenses and the international affairs appropriations are merged under one appropriation, the Office of the Secretary, salaries and expenses. The two representation funds were also merged, but not increased. The former OS, salaries and expense appropriation had a ceiling of $15,000 for representation and the international affairs appropriation had a ceiling of $80,000. In defense of this apparent large request, we would like to point out the following:

One, $95,000 is requested as a ceiling on representation expenses for fiscal year 1983.

Two, the OS representation funds are used not only by the Secretary, but by the heads of all of the Treasury bureaus for official reception functions. The funds are allocated very sparingly to the bureaus and requests are carefully reviewed.

Three, the bulk of the representation funds are used in connection with Treasury's responsibilities in hosting international meetings. Examples of fiscal year 1981 costs include: (a) Approximately $20,000 was used by Treasury financial attaches stationed at embassies overseas. The average allocation to each post was less than $1,500. With less than $30 per week, these attaches were expected to conduct working luncheons and dinners with their counterparts in foreign finance ministries and with the local financial communities, and to hold receptions to introduce new staff members to those foreign officials. Vouchers are rigorously examined to insure that funds are used only for those purposes; (b) In 1981, the United States hosted the annual meeting of the Asian Development Bank. At this event, the Secretary hosted a luncheon for the delegation members at a cost of approximately $13,000. This luncheon was attended by nearly 1,000 persons from 43 countries. Over 30 ministerial rank officials attended. The per capita cost was under $13; (c) The Treasury and the Federal Reserve jointly hosted a reception for the annual meeting of the International Monetary Fund/World Bank. It is estimated that 5,000 persons from over 140 foreign delegations attended that event. Treasury's expenses of approximately $30,000 amounted to a cost of approximately $6 per person; (d) Luncheons and dinners for other meetings (the Inter-American Center of Tax Administrators and the U.S.-Saudi Arabian Joint Economic Commission) were also paid for with these funds; and (e) The balance of these funds were used for working luncheons and dinners given by the Secretary and other senior officials for their foreign counterparts, for visiting tax treaty delegations; receptions for meetings of major Government advisory commissions; and for nominal gifts (such as medallions struck by the mint) to heads-of-delegations from foreign countries.

Four, by comparison, the State Department is requesting $3.9 million for representation purposes in fiscal year 1983.

### NEW FUNCTIONS FOR OMB IN 1982

Mr. STOCKMAN. In our case, I will point out that Congress did cut the President's request for OMB by 16 percent in 1982 from $38 million down to $32 million. The reason the request was up was that a whole variety of new functions and agencies were transferred to OMB during that year as the result of mandates by Congress.

The Paperwork Reduction Act we abolished. The Council on Wages and Price Stability moved a few of its people to OMB to work on regulatory affairs, and got rid of the rest. We had the Statistical Policy Office transferred from the Commerce Department in 1982 to OMB. Under the Executive Order we have had a huge increase in the workload to review each and every regulation that came along.

As a result of those additional responsibilities, we cut the Federal Register by 40,000 pages last year, reduced the new regulations by one-third, and reduced what we believe would be the unnecessary burden on American industry and jobs and saved $10 to $15 billion over the next couple of years. And we did all of that with the 16 percent cut in our budget for 1982.

Now, the 17-percent increase form the 1983 level really, in total, just offsets the 1982 reductions.

But let me comment further on the nature of the additional $4 million increase in 1983. First, $2.7 million of this is the result of increases in the rent GSA charges OMB for occupying the New Executive Office Building, Our SLUC charges rose from $13.48 to $29.34 per square foot.

Second, the amount for the October 1981 pay raise is included in the 1983 figures, but not the 1982 figures. This represents an additional $1.7 million.

These two uncontrollable items total $4.4 million, which means that our budget in other areas actually decreased. In fact, we are estimating a reduction of 20 workyears in 1983 from the 1982 levels.

### HOLDING WHITE HOUSE OFFICE BUDGET AT 1982 LEVEL

Senator DECONCINI. What would be the effect of maintaining the budget for the White House Office at the 1982 level?

Mr. STOCKMAN. The result would be a severe negative impact on the level of support provided to the President of the United States by the White House Office. As you know, the White House along with many other areas of the Federal Government, has been operating at a reduced spending level during the current fiscal year. The fiscal year 1983 request would allow operations to continue at this reduced level with no funds provided for expansions of any White House activity but with prudent increases included where necessary to maintain the high standard of support to the President. Two-thirds of the total increase is for items over which the White House has no control and the remaining third is for inflation.

Senator DECONCINI. Do you approve the 17-percent increase in the White House Office and the 17-percent increase in the Office of Secretary of the Treasury?

Mr. STOCKMAN. I can't say I approved each and every item in the budget. The White House budget was in the same position as OMB—they were cut 16 percent.

### FOREIGN ASSISTANCE

Senator DECONCINI. What about foreign assistance? Our total foreign assistance is up some $3 billion in this budget from the 1981 budget; did you approve that?

Mr. STOCKMAN. There has been a great debate, I know, in the Congress about that. Most of the increase is for military assistance in the form of foreign military sales credit. The reason the number looks inflated as much as it does is that we treat that in two categories, off-budget and on-budget. Congress tends to cut the on-budget request and move it off-budget. Then, next year we try to put it on-budget and it is put off-budget. In terms of total resources, the increase isn't as large as was implied.

Senator DECONCINI. In reality it is above 1981.

Mr. STOCKMAN. It is above 1981 because the previous administration made a whole variety of commitments to fund things like the IDA replenishment, and so forth, that we felt were necessary to continue.

Senator DECONCINI. Extract some $6 billion for the International Fund and World Bank, it is still up, is it not?

Mr. STOCKMAN. Yes; if you exclude two categories, foreign military sales credit and the IDA and others.

Senator DECONCINI. Wouldn't you consider foreign military sales and IDA and others as foreign assistance?

Mr. STOCKMAN. Yes.

## DEFICIT PROJECTIONS

Senator DECONCINI. Mr. Stockman, we hear a lot about the problems we face and I would like you to know that I share the concerns that I think you have expressed here. Many of us on this side of the aisle voted with the President on the Kemp-Roth modified tax cut and the administration program. We did it for a number of reasons. At least this Senator from Arizona did.

One is to give the administration an opportunity to see if this program would work; two, based on some representations that you and other members of the administration made during the budpet process.

At one time early on your predictions were that the gross national product would expand at a rate of 4.2 percent and the Federal deficit would decline from $54.9 billion in fiscal year 1981 to $45 billion in fiscal year 1982.

The midsession review revised the real GNP growth forecast downward to 3.4 percent and the estimated deficit fell slightly to $42.5 billion. Then last September the onset of the current recession became apparent and the estimates of the deficit rose to $60 to $90 billion.

The current estimate of real GNP growth for 1982, contained in the fiscal year 1983 budget and the Economic Report of the President, is 0.2 percent and the deficit projection has more than doubled to $98.6 billion. Both the budget and the President's economic report assume that the current recession will "be over by the second quarter of 1982."

Last week we heard the President extend that a little bit.

My question is, how much reliance can we have in your predictions that the deficit is only going to be 90 some billion assuming that we adopted the administration budget? Is it not fair to think that it is going to be a great deal more than it was in 1982?

Mr. STOCKMAN. Senator, I think you can come to that conclusion depending on where you think the financial markets are heading, where interest rates will be, how strong the recovery will be in light of the downward pressure from monetary policy, and so forth. For that reason, in parts 2 and 3 of the budget this year we have tried to provide a range of what the deficit would be with our policy measures and budget program for 1983 based on different economic forecasts. We are in such an unprecedented state of the economy and in such a volatile period of transition that no one should be overly confident about the forecast that they make. Nevertheless, you cannot write a budget without one. So we have our forecast and then high options and low options and pessimistic and optimistic forecasts above and below that.

If you consult the budget, you will see we indicate the deficits will be much larger if the growth rate is lower and the recovery is delayed.

But I will also say that when the budget was written last year—in the spring—forecasts were made by us and others in late winter. I don't think anybody expected at that time that money supply growth would drop to zero from about May to October and that the degree and duration of the recession that we have now was a likely prospect at that point in time. Even when we revised our budget in June, there were very few who saw this kind of recession or even the drop in money growth that occurred last summer.

So we have been surprised by economic events and we must now recognize that they have had a major impact on the budget. We must cope with the current circumstances and future prospects that we face as best we can in light of those changes.

Chairman HATFIELD. Thank you, Senator DeConcini.

### ADDITIONAL COMMITTEE QUESTIONS

Senator DECONCINI. I have some questions I would like to submit.

Chairman HATFIELD. Any member is certainly welcome to present Mr. Stockman with further questions in writing.

I had promised Mr. Stockman we would be out of here by 12:30. We have gone over our time due to a couple of votes that interrupted our session this morning.

Mr. Stockman, we appreciate your being here and responding to the questions and we will have additional questions to submit to you in writing.

[The following questions were not asked at the hearing but were submitted to the Office of Management and Budget for response subsequent to the hearing:]

## QUESTIONS SUBMITTED BY SENATOR MARK O. HATFIELD

### General

Question:

What fiscal actions would you regard as necessary to fulfill your expectations of vigorous growth before the end of 1982?

Answer:

The necessary conditions are enactment of the President's budget program, or at least a close approximation thereto. The President's program is designed to strike the best balance between tax and spending reductions to maximize economic growth prospects for the latter part of 1982 and beyond.

Question:

The Administration has placed strong emphasis on inherited economic programs and problems. Do you regard the 1981-1982 recession as another such heritage? When do you expect to be rid of this kind of burden?

Answer:

In the past decade and a half, American economic performance has deteriorated severely. Inflation rose from a 1 to 2% a year average in the early to mid 1960's to 13 1/2% in 1980. Starved by underinvestment and undersavings, productivity growth dwindled and for the past 5 years has ceased altogether. The unemployment rate has trended steadily upward from the 3 1/2 to 4% rate of 1965-1969 to 8.8% today. Short-term interest rates, which averaged 4% during the 1960's, averaged about 13% during 1980-1981.

We are now engaged in a transition to a new era of vigorous economic growth, increased savings and investment, and revitalized productivity growth, with restored price stability. This has required a bold reversal of past economic policies that precipitated stagflation. The current recession is part of the transitional adjustment of the economy to a much more desirable range of performance. There are signs that the recession is now bottoming out; it will require several years of vigorous, sustained growth, however, to bring unemployment down to substantially lower levels. We are already seeing significant progress in reducing inflation. Savings and investment should pick up sharply in the later part of this year, as the economic recovery gets well underway. Productivity improvements will follow, with a slight lag. Thus, the inertia of past stagflation will encumber economic performance, albeit to a steadily diminishing degree, for some time to come.

Question:

The President's budget message made the following statement: "People's savings are beginning to flow out of unproductive speculation, tangible assets, and other inflation hedges back into the Nation's financial arteries where they will be available to power economic recovery, more jobs, and growing incomes and opportunities." What is the basis for this optimistic statement?

Answer:

The evidence for this statement lies in markedly declining prices, and demand for precious metals and other tangible assets and inflation hedges. The price of gold, for example, was over $700 an ounce before the 1980 election; it has since dropped in half, to below $350 an ounce. Silver and other precious metals have also stopped increasing or have fallen in price. The softening of oil and of housing prices is part of the same phenomenon. When the economy bottoms out and turns up, the stock and bond markets will be seen to have greatly strengthened in relative terms.

Question:

Last year you attacked the frequent changes in outlay and revenue estimates, as creating a significant decline in confidence of the management of the nation's finances. How would you rate the Reagan Administration's performance in this regard?

Answer:

The budget estimates assume certain economic conditions, technical reestimates and enactment of the President's proposals. These assumptions are made nearly 18 months before the end of the year in question, and never predict events perfectly. As a result, final outlays and receipts always differ from estimates that were made earlier. For 1982, not all of the proposed outlay reductions were enacted. These and other factors result in the changes in receipt and outlay estimates. We do not believe the Administration's reestimates for these reasons affect confidence in the management of the nation's finances.

## Deficit

Question:

Last year before this Committee you stated that during the 1960's, the Federal debt as a percent of the total credit market was about 6%, whereas that proportion rose to 14% in the 1970's. You stated that these Federal credit demands had a debilitating effect on investment and economic growth. What are the predicted equivalent figures for 1982, 1983, and over the next five year period?

NOTE: The first sentence of the question should read "...during the 1960's, Federal borrowing as a percent of total funds raised in U.S. credit markets was about 8%, whereas that proportion rose to 15% in the 1970's."

Answer:

The equivalent figures are 21% in 1980 and 19% in 1981. We have no estimates of total funds borrowed in the domestic credit market for future years, and therefore do not have the data you request for 1982 and beyond.

Question:

The Administration has repeatedly made the point that under its new budgetary plan, Federal outlays, as a percentage of GNP will decline from 23% in 1981 to 19.7% in 1987. Most of the debate surrounding the President's budget, however, has been over the projected deficits. Seemingly, American public opinion is more concerned about the deficit than about the percent of GNP that Government consumes. Is it your view that reducing the Government's share of GNP is a more important goal than a balanced budget?

Answer:

The long-term goal of a balanced budget is an important one. However, we dare not follow the policies of the past that continually raise taxes and spending, thus increasing the role of the Federal Government. Rather than balance the budget on the backs of the taxpayers, this Administration intends to continue to reduce Federal taxes and Federal spending and to eventually balance the Federal budget at a substantially lower share of GNP than existed when this Administration took office.

## Uncontrollables

Question:

According to OMB, uncontrollable spending now exceeds 75% of the Federal budget. One component of uncontrollable spending, entitlements, will rise from $119 billion as recently as 1979, to a projected $201 billion in 1983. The President's 1983 budget proposes substantial reductions in these programs. Do these proposals represent what the Administration actually would like to see for these programs, or are the budget reduction targets tempered by political reality?

Answer:

The budget estimates do, indeed, indicate that over 75% of 1982 and 1983 outlays are for relatively uncontrollable outlays. However, the entitlements component of these is far greater than the question implies -- non-social security entitlements rose from $103 billion in 1979 to an estimated $174 billion in 1983, while social security entitlements rose from $103 billion in 1970 to an estimated $174 billion in 1983. While the budget proposal is to reduce non-social security entitlements by $11.7 billion, this is only 6.3% of the non-social security entitlements or 3.3% of total entitlements including social security. While this is a start toward controlling or limiting entitlements, it is far from a drastic reduction.

The proposed reductions represent what the Administration believes to be both feasible and equitable. The reforms the Administration is currently proposing for entitlements are restricted to the non-social security portion; it is waiting for completion of a detailed study of social security by the National Commission on Social Security Reform before proposing reform proposals for social security.

Question:

Has the extraordinary growth of these programs brought about a situation where the Congress should re-examine the whole notion of "entitlements," and convert many of these programs back to a discretionary annually appropriated basis?

Answer:

There certainly is merit to the idea of the Congress reexamining the basis for many of these programs. Obviously, it is impossible to simultaneously guarantee to people automatic access to predictable benefit levels for programs such as medicare, unemployment assistance, and employee retirement and to simultaneously retain effective appropriation control over the spending levels of these programs. We must strike a balance between meeting the legitimate desire of people for financial security and our obvious need to control Federal spending. To the extent that the reexamination of the fundamental roles of government now underway results in leaving both the responsibility for self help on the individual and -- through lower taxes -- also leaves the individual with the means of self help, we will automatically correct part of the problem. But, clearly, we must take cognizance of the limits of our ability to do all that we might like to do as well as to realize the perverse effects of paternalism. Hence, a careful review of the size, scope, and eligibility standards of these programs is warranted.

## Investment

Questions:

Last year you stated that during the first half of the 1960's federal investment as a proportion of federal expenditures was 40% whereas in the 1970's, the figure was only 15%. What is the equivalent figure for FY 82, 83, and for the next five year period?

You termed this process capital consumption, rather than capital expansion, and stated that the U.S. "through the breakdown of its fiscal policy has embarked on the dangerous path of consuming its own capital and living off its own savings." Has the Reagan Administration been able to alter this situation?

Answer:

The best available data on investment-related Federal spending are from the Special Analysis on "Investment, Operating, and

Other Budget Outlays" published in conjunction with the budget each year. While the data are not totally comparable over the span from the early 1960's to the 1980's, they are reasonably comparable and they reflect major trends.

For the early 1960's, nondefense Federal investment-type outlays were about 26% of total nondefense outlays. For the 1970's, they were about 22%. For 1982 they are estimated to be 15.0%, and for 1983, 12.8%. We do not have projections for these data beyond 1983.

The decline as a percent of total nondefense outlays can be attributed to several reasons:

1) the rapid growth of some nondefense current outlays, primarily social security and net interest, which increases the denominator used for the percentage;

2) returning to State and local governments the responsibility for their own investment-type activities. This includes especially transportation, pollution control, education and training activities; and

3) the removal of the acquisition of oil for the strategic petroleum reserve from the budget totals.

These changes do not threaten the condition of Federal nondefense investment-type outlays for items that properly fall within the Federal role.

## Management Initiatives

### Question

The "deficit reduction program" is presumably reflected in the budget authority requested. How, though, does the $20.3 billion in management initiatives fit into the budget authority requests for agency appropriations? Specifically, what are your assumptions regarding the $1 billion each for savings from reduced fraud, waste, abuse and from improved debt collection? What is the relationship between these additional savings and specific appropriations account reductions and general provisions which are included in most bills?

### Answer

The allowances for savings associated with these two management initiatives -- reduced waste, fraud, abuse and improved debt collection -- are calculated completely independently of specific requests for appropriations. The $1 billion in savings for each of these two initiatives included in allowances are determined on an aggregate basis only.

The $1 billion savings claimed from improved debt collection represents two types of savings. Approximately $500 million represents projected savings from enactment of debt collection legislation now pending in Congress. This legislation includes

H.R. 4613, H.R. 4614, H.R. 5471 and the complementary Senate Bill 1249. The major savings in these legislative initiatives will come from the redisclosure of IRS addresses, charging of interest and penalties on late payments, and the use of credit bureaus. The remaining $500 million represents Government-wide administrative improvements, including improvements in the litigation of debts owed the Government by the Justice Department. These savings are not assigned to particular accounts. However, these savings are in addition to an estimated $1.3 billion in debt collection savings expected to be recovered through initiatives already underway. The $1.3 billion is distributed in the Budget by agency account, resulting in reduced outlays for each of the Federal departments and agencies that have sizeable delinquent debt.

The $1 billion savings from decreased waste, fraud and abuse is based on projected results from continuing activities of the Inspectors General. The President's Council on Integrity and Efficiency was established in March, 1981 to spearhead the Administration's campaign to reduce fraud and waste in the Federal government. In addition, the Administration is involved in comprehensive efforts to:

- eliminate excessive and unnecessary publications and audio visual expenditures;
- eliminate abuse of Federal travel regulations;
- strengthen internal management controls against fraud and waste;
- require major agencies to update their fund control regulations and submit them for approval; and
- expand the development of model control systems to such areas as consulting services, long-term training, space acquisition, and procurement office equipment.

## Budget Specifics
## Federal Employment

### Question

An OMB spokesman stated about 2 weeks ago that between 2,800 and 4,000 Federal employees have been laid off since President Reagan took office. This figure is just a fraction of a previous estimate of 12,000 to 18,000. What is the figure, and what additional RIFs do you expect in FY 82 and FY 83? What budget savings result from these cuts?

### Answer

The 2,800 and 4,000 figures were provided to OMB, informally, by the Office of Personnel Management some weeks ago on a preliminary basis. The most recent information provided by OPM indicates that from January 1981 through September 30, 1981, the number of Federal employees released as the result of reductions in force (RIF) was 2,739, with an additional 4,207 between October 1 and December 31, 1981, for a total of 6,946 during calendar year 1981. However, within the 4,207 for the last quarter of 1981, 2,900 were employed in Public Health Service (PHS) facilities that were terminated as Federal facilities. Out of these 2,900, 1,800 were immediately employed by State and local entities that took over the operation of some of the former

PHS facilities. The net figure for calendar year 1981 is, therefore, about 5,100.

The 12,000 to 18,000 estimates were made by sources outside the Administration early last year.

OMB does not project RIF figures. We anticipate that the bulk of the planned reductions will be achieved through attrition and elimination of unfilled positions. As indicated on page 248 of the 1983 Budget volume entitled, Major Themes and Additional Budget Details, we have estimated that once the planned 75,000 workyear reduction becomes fully effective in fiscal year 1985, the annual savings will amount to about $2.1 billion. A reduction of another 75,000 workyears over the 1985-1987 period is projected to provide further savings of $2.3 billion by 1987 (pages 3-11, 12; Budget of the U.S. Government, fiscal year 1983).

## Defense Budget

### Question

"Implied Deficits": The budget focuses on what are termed "implied deficits," which are constructed from the current services outlay total, combined with the President's defense package. The gap between those outlays and receipts under current law is $146 billion in 1983 and climbs to $175 billion by 1987. Congress is asked to enact "deficit reduction proposals," including a $14 billion reduction in discretionary appropriations, to reduce these implied deficits.

Do you agree that this approach could be very misleading in that it builds defense spending into the starting point and thereby ignores the careful scrutiny which the Congress intends to give to every part of the President's requests for defense?

### Answer

No. Inclusion of an adequate defense in the current services baseline from 1983-1987 shows the President's determination to provide substantial real increases in defense resources. This is necessary because since the 1970's the United States has allowed its military power to decline relative to the growth in power in the Soviet Union.

## Reduced Outlay Growth

### Question

One of the major themes in (Part 3) of the budget is that of the reduced growth of outlays.

To illustrate how the President's budget reduces the growth of outlays you have reconstructed the Carter budget with "adequate defense" and compared last year's budget reductions to this base. Your claim is that last year's extraordinary reductions brought the growth of outlays down from 12% to around 8% and 10% respectively in FY82 and 83.

Two questions:

1) Isn't it overly optimistic to assume that even more extraordinary measures will take place in one year so as to achieve your FY83 goal of 4.5% outlay growth?

2) Why is it that, in the outyears, the outlay growth rate comparison to the Carter budget (even with "adequate defense") shows that last year's efforts result in even higher outlay growth than before the Reagan program was adopted?

Answer

1) It is absolutely essential that the growth of Federal spending decline and we must enact further reductions to bring about the decline. Continued high levels of Federal expenditures are not acceptable. We therefore do not believe it is overly optimistic to expect outlay growth of 4.5% in 1983.

2) The reductions enacted in 1981 decrease the base by an estimated $269 billion for 1982-1987. Because the reductions are relatively greater in the earlier years, the statistical anomaly noted above occurs.

## Current Services Baselines

Question

The deficit reduction program is constructed from a baseline which combines a current services budget with the President's defense program. This baseline is presented in the budget in terms of total outlays. As you know, this Committee's spending jurisdiction is roughly half of the total budget. Can you suggest a method by which each subcommittee could have your estimate of what is in this baseline starting point so as to avoid confusion when individual bills are considered by Congress?

Answer

The Congressional Budget Act of 1974 requires that the President submit to the Congress estimates of the outlays and budget authority needed to maintain the Government at a current services level. The estimates allow for the future implications of current law, the anticipated changes in those programs that are relatively uncontrollable, and since 1982, include the effects of inflation on virtually all budget accounts, including discretionary programs.

Detailed current services estimates for 1982 and 1983 are provided by function in Special Analysis A- Current Services Estimates and by account in budget data submitted to the Congressional Budget Office. However, long-range current services data for 1984-1987, using budget year economic and programmatic assumptions, was estimated by OMB in large aggregates for broad comparison purposes and is not available in detail.

## Defense Budget

### Question

I would like to focus a moment on the impact of military spending on the economy. A study completed by Employment Research Associates, shows that military spending seriously depresses employment in the United States. In fact, its comprehensive analysis reveals that every time the military budget goes up $1 billion, 6,500 jobs will disappear in the U.S. According to this data, then, the negative employment impact of the President's 1983 budget for defense--$215 billion in outlays--is 1.4 million jobs foregone. What is your view on this matter?

### Answer

The primary objective of the Administration's plan to provide significant increases for defense resources is to maintain a strong national security posture--not to create jobs. However, increases in defense spending in 1983 and beyond will result in increased defense production which will help stimulate growth and reduce unemployment.

### Question

In the oft quoted Atlantic Monthly article, you stated that "there is a kind of swamp of $10-$20-$30 billion worth of waste that can be ferreted out (of the Defense Department) if you really push hard." Yet, we see an increase in defense spending of $43.4 billion in budget authority over FY 1982. Is defense the sacred cow it appears to be? Has that so-called swamp of waste been touched?

### Answer

Eliminating waste and inefficiency is a matter of the highest priority. On February 8, Secretary Weinberger announced details of actions taken to save more than $51 billion by 1987. These savings include the results of government-wide actions relating to civil service compensation. However, they also include the results of reform of the defense acquisition process and the management of defense operations. OMB played a role in producing these savings through our membership on the Defense Resources Board, our involvement in the joint review of the defense budget, and our part in developing the government-wide actions.

Increased efforts to combat waste, fraud and abuse include close monitoring, revision of defense programs and policies, and active follow-up of audit findings. To help accomplish this task, Secretary

Weinberger has created a new position of Assistant to the Secretary of Defense for Review and Oversight.

## Non-defense Discretionary Outlays

### Question

Pages 3-21 of the Budget contains an analysis of the growth in budget outlays. Non-defense, non-entitlement outlays are shown at the following levels:

(in billions of dollars)

| Fiscal Year | Outlays |
|---|---|
| 1982 | 129.9 |
| 1983 | 98.7 |
| 1984 | 92.3 |
| 1985 | 89.2 |
| 1986 | 85.2 |
| 1987 | 83.5 |

As Mr. Dale pointed out in the attached article, these are net outlay amounts. In other words, if offsetting receipts were not taken into consideration, discretionary program outlays would be higher. For example, Mr. Dale estimates that "true" discretionary outlays in 1983 are $139.9 billion.

Please provide your estimates for the fiscal year 1982-87 of the "accounting offsets" which should be added to the above totals.

Furthermore, for fiscal year 1983, this "true" discretionary outlay total of $139.9 billion would include outlays from prior year authority. How much are these prior year outlays in 1983? Can you provide any outyear data?

### Answer

The figures you have cited are, indeed, outlays for non-defense discretionary programs that are net of offsetting receipts. Outlays totals that do not deduct offsetting receipts are as follows:

(in bilions of dollars)

| Fiscal Year | Net Outlays | Offsetting Receipts | Gross Outlays |
|---|---|---|---|
| 1982 | 129.9 | 29.0 | 158.9 |
| 1983 | 98.7 | 41.2 | 139.9 |
| 1984 | 92.3 | 46.5 | 138.8 |
| 1985 | 89.2 | 48.1 | 137.3 |
| 1986 | 85.2 | 51.1 | 136.3 |
| 1987 | 83.5 | 54.3 | 137.8 |

Of the outlays in 1983 for discretionary programs, about 56% are from prior year outlays. OMB does not collect this data from the agencies beyond the budget year. Thus, I am unable to provide any outyear data.

## QUESTIONS SUBMITTED BY SENATOR HARRISON SCHMITT

### The Role of the Appropriations Committee

Question:

Last year, you prepared the President's budget in the traditional way, making budget authority estimates based upon existing legislation, but then proposing further reductions for later transmittal, based upon recommended enactment of changes in authorizing legislation.

Why did you choose to deviate from that plan this year submitting budget requests which already assume enactment of an array of changes in authorizing legislation?

Answer:

In the past, the method of presenting reductions that required changes in substantive law may have resulted in misleading scorekeeping of the Administration's request currently by the Congress. Although in several cases the appropriations request assumes enactment of authorizing legislation, inclusion of these reductions reflect a more realistic request than would be achieved by submitting these proposals in a piece-meal fashion.

Questions:

Are you suggesting that the Appropriations Committee should reverse its traditional policy of acting only on authorized programs?

If the authorizing committees fail to make changes in entitlement programs, would you recommend the appropriations process be utilized to make the statutory changes proposed by the President?

Answer:

The Administration is not suggesting that the Appropriations Committee circumvent the traditional legislative process. Our intention, however, is to provide the Appropriations Committee with the clearest and most accurate estimate available of budgetary needs. The Administration recognizes the importance of the Authorizations Committees' role, and has never supported the addition of substantive language to appropriations bills.

Question:

Let's assume, for a moment, that the Appropriations Committees and Congress decide to "hold the line" on spending for discretionary social programs at last year's level, and delay action on proposed changes in entitlement programs so that virtually no savings can be achieved during Fiscal 1983 below currently mandated spending levels.

How would such an outcome change your projections for the Fiscal 1983 average unemployment rate, inflation, interest rates, and the Federal deficit?

Answer:

Such an outcome would have very serious implications for the expected economic recovery. If all of the President's deficit reduction measures were ignored, including tax revisions, the budget deficit would be an estimated $55.9 billion higher than in the President's budget. This would most likely prevent the expected recovery, resulting in higher unemployment, interest, and inflation rates.

Question:

If it became crucial that political support for enactment of the "new Federalism" proposals hinged upon maintaining several programs at approximately current levels through Fiscal 1983, would the Administration be willing to accept such a compromise?

Answer:

The President's proposal is presented as a framework rather than a final proposal. The final program will depend on considerable consultation with representatives of State and local governments, the Congress, and others. The President has indicated his willingness to continue the funding levels for programs included in the Federalism initiative at the levels enacted for 1983.

Question

Have you instructed the agencies that they need not submit reprogramming requests to the Appropriations Committees for subactivity deviations from the 4 percent reductions?

Answer

No.

Question

Must Congress actually amend the Continuing Resolution to require the Administration to seek reprogramming authority whenever it seeks to redistribute the 4 percent cutbacks among subactivities of each appropriation account--or will you respond to statements of Congressional intent?

Answer

Generally, the reprogramming procedures for the various departments and agencies and their Appropriations Subcommittees are established, and adhered to, without specific involvement or direction by OMB. We believe that this practice should be continued.

## Economic Contingency Plans

Question:

What contingency plans are being considered in the event the economy moves into a deep, prolonged recession?

Answer:

The Administration does not foresee a deep or prolonged recession. The policies presented last year and continued this year, primarily tax and spending reductions, reductions in regulations, and restrained growth in the money supply, should set the stage for steady economic growth. In view of this, the Administration does not have contingency plans.

Question

If the predicted economic recovery fails to materialize, some Members of Congress may begin pressing for further economic recovery measures, such as extended unemployment compensation legislation. What response will the Administration have to such moves?

Answer

The unemployment compensation extended benefit program under existing law is responding to the current recession. In October-November 1981, extended benefits were payable in five high-unemployment states and Puerto Rico. By March 1982, extended benefits were payable in 26 states and Puerto Rico. Under the economic assumptions used in the President's Budget, extended benefits would be payable in about 46 states and jurisdictions during FY 1982. We believe the extended benefit program now in place is sufficient to respond to the jobless levels of this recession.

Question

How much would it cost in Fiscal 1983 to reinstate the national trigger for extended unemployment benefits which was eliminated in the 1981 reconciliation legislation?

Answer

Reinstating the national trigger alone would increase FY 1983 outlays by $1.8 billion. We believe that this would be an unnecessary and unwise use of funds. The extended benefit program targets additional weeks of benefits on high-unemployment states. Under the economic assumptions in the President's Budget we estimate that extended benefits would be payable in 22 states and jurisdictions in 1983. It would not make programmatic sense to reinstate a national trigger and require payment of additional weeks of benefits in all states, including those where workers are not experiencing more than ordinary difficulties in finding jobs.

Question

How much more would it cost if Congress repealed last year's Reconciliation Act provision, scheduled to go into effect this October, which raised the State extended unemployment benefit "trigger"?

Answer

Repeal of the change in state trigger rates alone would increase FY 1983 outlays by $1.3 billion. The shift in triggers which will take effect in FY 1983 will direct extended benefits to the states where they are needed most. We estimate that they would be payable in 22 states and jurisdictions during FY 1983.

## Federal Credit Budget

Questions:

The Federal credit budget for Fiscal 1983 is $147 billion — roughly a 2.5 percent increase over Fiscal 1982. When added to the projected $91 billion deficit in the cash budget, Federal borrowing in Fiscal 1983 appears to exceed $200 billion.

Is Government borrowing swamping the credit markets?

Answer:

The degree of Federal participation in the nation's credit markets is unacceptably high. From 1955 through 1975, Federal and federally assisted borrowing, on average, absorbed less than 20% of available credit resources. This includes borrowing by the Government to finance the budget deficit and off-budget spending, borrowing by individuals or private institutions with Government-guaranteed loans, and borrowing by Government-sponsored enterprises. In the latter half of the 1970's, large deficits and rapid expansion in credit programs drove the average absorption up to 28%. The absorption levels reached in 1980 and 1981 (36% and 35%) have been experienced before only during the recession and recovery period of 1975-1976.

Unprecedented Federal credit demands reduce the nation's ability to improve productivity and output. Increasing demand for credit by the Government and the borrowers it serves saps the vitality of credit markets and hampers their performance in the critical task of allocating resources to the most productive uses.

- Many unsubsidized private borrowers are crowded out of the "credit queue" because priority is given to Federal and federally assisted borrowers.
- Federal intervention distorts the market's assessment of risk and return, causing a misdirection of investment and a decline in future economic growth and productivity.

— Interest rates are exposed to continual upward pressure. With Federal borrowing absorbing so much of the supply of credit, private borrowers are forced to bid interest rates up.

Questions:

What efforts are you making to control the Federal credit budget?

Over the next five years, do you foresee a decline in the Federal Government's share of total borrowing, in order to alleviate upward pressure on interest rates?

Answer:

Upon assuming office, the Administration took immediate steps to reverse the growth trends of Federal credit. An interagency Cabinet-level group was formed and undertook a comprehensive review of the Government's direct and guaranteed loan programs in order to shape a consistent credit policy. The credit budget was used for the first time to impose systematic discipline and policy control on the growth of Federal credit. The group also recommended modifying Government-sponsored enterprises into becoming completely private organizations. Additional policy changes will be recommended and implemented in the months ahead.

In its credit budget revisions just after taking office, the Administration proposed reductions in direct and guaranteed loan activity for 1982 of $21.0 billion below the level proposed by the previous Administration. The 1983 credit budget continues this steady downward path in the total burden of Federal credit demands on the nation's economy. In particular, the Administration's credit budget proposals bring direct loan obligations down by $7.4 billion between 1981 and 1983 and substantially slow the growth in guaranteed loan commitments compared to previous growth trends. A large number of major programmatic changes will have a strong effect over the next five years on the effects of Federal credit activity. Major changes are the following:

Government National Mortgage Association. Loan commitments for GNMA mortgage-backed securities are proposed to decrease by $9.6 billion between 1982 and 1983. Private mortgage-backed securities programs are now rapidly developing; the Administration's GNMA proposal would encourage and accelerate the success of these private efforts.

Export-Import Bank. Direct lending will be reduced by $0.6 billion between 1982 and 1983, and guaranteed loans will be held at the 1982 level. Because of the decline in demand for direct credit and the potential for the private sector to undertake increased insurance activity, these amounts will be sufficient to enable the Export-Import Bank to meet the requisite needs of exporters facing subsidized foreign competition.

Farmers Home Administration. The Administration believes that private lenders are increasingly able to fill rural credit needs adequately. Accordingly, program reductions proposed in FmHA total $2.6 billion in direct loans and $0.6 billion in loan guarantees. These changes include major decreases in direct loans for rural housing, and termination of the business and industrial, and alcohol fuels, loan guarantee programs.

Rural Electrification Administration. In 1983, REA guaranteed loans will be reduced by $0.5 billion and direct loans will be reduced by $0.4 billion. These reductions are proposed because a large number of REA borrowers can obtain credit from unsubsidized private sources at prevailing market rates.

Small Business Administration. The Administration is proposing to eliminate SBA direct loans beginning in 1983 and to reduce 1983 guarantees by 10% below the 1982 level. These reductions are proposed as part of the overall plan to control credit, because small businesses will benefit more from stable financial markets and lower interest rates than from Federal credit assistance for a few selected borrowers.

Commodity Credit Corporation. Direct loan obligations for commodity price support programs are estimated to decrease by $2.0 billion between 1982 and 1983 due to provisions in the recently enacted Agriculture and Food Act of 1981.

Question:

What do you think of the idea of offsetting any projected increase in the Federal cash budget deficit, over the $91 billion Administration estimate, with further reductions in the Federal credit budget?

If the Federal credit budget had to be cut another $20 to $30 billion, where would you suggest the cuts be made?

Answer:

The President's 1983 credit budget proposals represent a very thorough policy review of all direct and guaranteed loan programs. All program reductions that were feasible were proposed. However, further reductions, beyond those proposed, could have beneficial effects in reducing the Government's claim on the nation's financial markets. The Administration would need to consider any further credit budget cuts as they are proposed in order to analyze them adequately.

Question:

A survey of small businesses indicates, despite recent layoffs, many firms plan to increase hiring during the First Quarter of 1982. Since the vast majority of jobs are created by small businesses, wouldn't this seem to indicate the unemployment rate may soon begin to decline? When do you predict an end to the current recession?

Answer:

There are always many firms hiring new workers and many laying people off or even going out of business, even in normal times, and, indeed, even during economic boom periods. In a recession, the net outcome shifts to more layoffs than new hires, or to net gains in employment lower than the rate of growth of the labor force, so that the unemployment rate edges up.

Our expectation is that the economy will show a small positive gain in the second quarter of the year, and vigorous growth in the second half, extending into 1983. Declines in unemployment usually lag a month or two, on average, behind indicators of increased production.

## Indexing Treasury Debt Securities

Question:

In a recent article, Fortune Magazine proposed an alternative method of borrowing funds that could save $28 billion on Fiscal 1984 interest expenses. They propose to issue inflation-adjusted Treasury notes that pay a small real interest rate instead of the present high-fixed-rate securities.

What are your feelings about the feasibility of this proposal?

Answer:

The subject of indexing Government securities has come up from time to time over the years, especially during periods of significant inflation. The Treasury is concerned that such measures, designed to soften the impact of inflation on particular investor groups, would conflict with the broader objective of reducing inflation itself.

This indexed bond scheme is subject to several objections. First, in selling such bonds, the Treasury would tacitly lend official credence to fears of erratic inflation rates -- and real interest rates -- in the future, and give credibility to those who believe that Government is giving up on efforts to prevent such erratic inflation. This could, in fact, make the control of inflation even more difficult. Our priority should be to reduce inflation, not to insure people against it.

Second, issuing such bonds would give credence to the view that inflation will be very high for many years. Because most investors do not believe this, we do not think there would be many buyers for inflation-adjusted securities. This can best be explained with an example. Twenty-year fixed rate Treasury securities are now selling for about 13%. If inflation-adjusted securities were set at 3% above the inflation rate and inflation were now 10%, then investors could chose between 20-year 13% fixed-rate securities, or 20-year 13% inflation-adjusted securities. Those who believe inflation will average more than 10% per year for the next 20 years would buy the inflation-adjusted securities. We think there are very few such investors, and we do not want to officially sanction their view. In addition, we do not think it is appropriate or administratively cost-effective to create a very complex securities market for that special group.

Thirdly, the issuance of indexed securities could weaken the ability of the Government to maintain price level stability. It would require us to respond to inflationary developments by increasing payments to investors, and related Federal outlays, at a time when there should be restraint on budget outlays and on growth of the money supply. Indexing Treasury bonds or other government securities, therefore, would add one more escalator to the mechanism by which the dynamic process of inflation is speeded through the economy. It would cause one price rise to lead to another.

Finally, we do not believe that $28 billion in 1984 interest outlays could be saved by indexing securities. It should be noted that over the post World War II period interest rates on Federal debt have—on the average—been no higher than the rates of inflation and frequently have been lower than the inflation rate. Hence, by historical standards indexed bonds might have been a bargain for investors even at zero real interest rates. While we project the real rate of interest, or risk premium, to remain positive and fairly large (about 4%, 1982-85), with inflation declining and nominal interest rates remaining high, forecasting interest rates is very problematic, and real interest rates could be a lot lower. If so, inflation-adjusted securities could result in higher interest costs than if Treasury continued to issue only conventional fixed-rate securities.

Rather than insulating particular investors from the effects of inflation, we should concentrate our efforts on dealing with the causes of inflation. The President's economic recovery program is an integrated and comprehensive program designed to reduce inflation and encourage economic growth.

## QUESTIONS SUBMITTED BY SENATOR DENNIS DECONCINI

### Law Enforcement

Q. If this Administration is really serious about cracking down on the drug traffic problem in this country, why do you continue to talk tough on the one hand, and submit stand-pat, law enforcement budgets on the other?

A. The Administration's "get tough" approach to law enforcement is many faceted, going beyond simply the level of resources committed. In short, we believe the combined strategy of new legislative authorities, realignment and redefinition of the roles of enforcement agencies and better targeting of resources will result in a more effective enforcement strategy. I should also point out that law enforcement budgets have been protected from the magnitude of cuts proposed elsewhere. It is significant to note that the

1983 request for all agencies involved in drug enforcement, for example, totals $703 million -- a 49% increase from 1979 levels.

- Coast Guard. The Coast Guard has been shifting resources to meet pressing needs. Their marijuana interdiction capability in South Florida is being enhanced by redeploying one or more Coast Guard vessels from the west coast. The Coast Guard vessel stationed off Haiti since last October to deter illegal Haitian immigration has reduced the amount of drug traffic coming through the Windward Passage. That patrol has caught several smugglers as a by product of its presence off Haiti. The Coast Guard is reducing its personnel in areas other than south Florida; it is taking these cuts from support and operational areas unrelated to drug interdiction.

- Customs. Customs is also redeploying resources to meet pressing needs. Approximately 8% of the Service's tactical interdiction workforce will be relocated from low smuggling threats and low productivity areas to the high threat areas of the Gulf and Southeast. Criminal investigations will be retargeted with greater emphasis on special operations designed specifically to increase enforcement results. (Three such operations currently being developed are Operation El Dorado, a national effort directed toward the seizure of illicit cash flows associated with narcotics traffickers and other organized criminals; Operation Exodus, an effort to develop a threat assessment of critical technology export violations and implement a program to prevent illegal exports; and, Operation Fair Trade, a national effort to target fraud violations in two important industries--textiles and consumer electronics).

- DEA. The recent move to bring DEA under the authority of the FBI is anticipated to improve Federal drug enforcement efforts.

  - The Department of Justice believes that through joint investigations, DEA and FBI can be more effective in cases that involve organized crime, public corruption, and drug trafficking. The number of joint investigations has increased from 15 in June, 1981 to 125 in January, 1982.

  - The new organizational relationship will expand the enforcement techniques available to drug enforcement. Our ability to investigate and prosecute drug cases will benefit from the FBI's authority to use court-ordered electronic surveillance and from the FBI's capability in financial analyses.

  - From a resource standpoint, the new relationship will increase the number of staff and resources devoted to drug enforcement. (FBI estimates that it will allocate $17.8 million to drug work in 1983.) We also expect to gain operating efficiencies over time as the agencies identify unnecessary duplication in such areas as travel, office location, airfleet use, and other operations.

- FBI. The majority of the 408 direct position decrease in the FBI represents unfilled and unfunded positions, mostly clerical. The FBI will actually be increasing its personnel resources from current on-board strength. Furthermore, the FBI will shift resources internally to concentrate on high priority issues. The Bureau has already sent 43 additional agents to south Florida.

- INS. The Administration has been clear in its efforts to strengthen immigration enforcement. In 1981 we submitted the Omnibus Immigration Control legislation which included sanctions against employers who hire illegal aliens. This legislation is generally viewed as instrumental in stemming the flow of illegal immigration and strengthening the impact of INS enforcement programs. Concurrently, the Administration submitted a $108 million 1982 budget amendment to add resources to INS enforcement and detention activities. The Congress accepted $60 million of that request and the 1983 budget continues to fund those activities.

Q. How much money is included in 1983 in the Defense Department and law enforcement budgets to fund posse comitatus activities?

A. The 1983 budget does not include specific funds for posse comitatus activities. The Administration believes it gains valuable drug enforcement intelligence and assistance from on-going military surveillance activities. In such cases, the cost of regular military operations are already included in the Department of Defense budget, and no reimbursement would be required from domestic law enforcement agencies. In those cases where specific and special military operations are requested by Justice, Treasury, or Coast Guard, the requesting agency would reimburse Defense.

Those costs cannot be projected at this time, since the specific missions that might be requested are not yet known. At any rate, reimbursements would be paid from the overall enforcement or intelligence program of the requesting agency and would not be viewed as a separate program.

A summary of where we stand on implementing posse comitatus includes the following:

- The Navy has agreed on a non-reimbursable and non-interference basis to alert the Coast Guard and EPIC of any vessels they spot in the Caribbean and Atlantic that fit the smuggling profile.
- The Air Force and DEA are working on an agreement that would have the Air Force provide, directly to EPIC, radio and photographic intelligence from reconnaissance in the Caribbean.
- DoD will reschedule some training and normal operational assignments to increase opportunities to provide more assistance to requesting agencies on a non-reimbursable basis.
- Further agreements are pending DoD's promulgation of guidelines for responding to requests for military assistance. We anticipate that specific tasking orders to DoD will be carried out on a reimbursable basis.

## Posse Comitatus

Question

Could you tell us how much money is included in the Defense budget to support the posse comitatus legislation?

Answer

No funds are specifically budgeted by DOD in support of this legislation.

Posse Comitatus is included in the General Provisions of the '82 Defense Authorization Act. It provides that governmental agencies are to make requests to DOD for assistance and that DOD may respond on a reimbursable basis. However, the Defense Department is reviewing its military training and operations programs to determine which programs can be used to assist civilian agencies without a need for reimbursement or any adverse impact on military operations. DOD believes there will be many opportunities where the military can provide assistance incidental to their normal operations or through rescheduled operations. So far DOD has provided assistance to Customs and DEA. However, no overall assistance program has been determined.

## COLA-FEDERAL RETIREES

QUESTION: What is your rationale for decreasing Federal retirees COLA's to the lesser of the Consumer Price Index or the cost-of-living adjustment for Federal workers in light of the reductions that Federal retirees have already been forced to absorb?

ANSWER: Since annuities have been adjusted regularly to reflect full increases in the cost of living, retirement benefits have risen at a faster rate than pay. This has produced an incentive for individuals to leave government service, particularly, experienced senior personnel. We believe that the government's active and retired workforce should be accorded similar protection against inflation.

QUESTION: In the FY 83 Budget, you propose that Federal retirees receiving over 120% of the comparable current award (what Federal workers retiring today at the same step and grade would receive) should receive no cost-of-living increase. And you propose that retirees receiving between 100% and 120% of the comparable current award should receive 75% of the COLA. You estimate a savings of $489 million with this change and the change in figuring the COLA. What is your estimate of the number of retirees who will fall into these two classes?

ANSWER: Approximately 650,000 retirees would receive no cost-of-living adjustment in March 1983, because their annuities exceed the 120% limit. Some one million annuitants would receive 75% of the March 1983 adjustment.

## Defense Budget

Question: Deputy Defense Secretary Carlucci in his Testimony before the Armed Services Committee has maintained that the management and cost reduction initiatives undertaken by Secretary Weinberger have wrung the budget dry of unneccessary Defense spending. Mr. Stockman, do you agree with the Secretary's assessment of the Defense budget, particularly as it applies to the procurement process which in the past has been plagued by overruns in such key weapons programs as the HELLFIRE Missile, the M-1 Tank, the HARM Missile, and the ROLAND Air Defense System, just to name a few?

Answer: We do feel that the FY 1983 Defense budget is solid and represents a fair statement of needs. The economies and efficiencies efforts of the Secretary and Deputy Secretary of Defense have had a significant effect on the formulation of this budget. Two initiatives for improving the procurement process, for example, are contracting for weapons on a multiyear basis and buying systems at economic production rates. Both we and Defense will continue to look for ways to satisfy our national security needs at the lowest cost possible.

## Veterans Administration Budget

Question:

I was pleased to see that the FY 83 Budget for the Veterans Administration includes an increase of $530 million for the Department of Medicine and Surgery plus an increase of 1,167 in personnel. The increases in the Medical Research and Construction accounts of $9.6 million and $137 million respectively are also reassuring. However, it is my understanding that the inflation factor used in developing the Medical care budget other than personnel services was 5.4%. Is that figure accurate? If so, isn't that a rather gross underestimate of the rate of inflation?

Answer:

The FY 1983 Medical care budget request includes $198.9 million for non-personnel medical inflation, including allowances for medical technological improvements. This represents a net increase of 7.7% and is composed of two parts:

1. a 5.9% increase for all non-personnel service costs (consistent with the Administration's Fall estimate of the consumer price index increase); and
2. an additional 2% increase for such non-personnel costs as medical supplies and materials, contract and fee services, and equipment. The additional 2% allowance is requested for increases resulting from improvements in medical technology.

These allowances provide for more than the Administration's estimate of the change expected in the consumer price index.

## Recent Reagan/Volcker Meeting

Q. Mr. Weidenbaum: Several days ago, President Reagan and Chairman Volcker of the Federal Reserve Board met to discuss, presumably, current economic conditions. The President emerged from that meeting to say that he endorses the Federal Reserve's current policy and that it was necessary to have fiscal and monetary policies work together rather than at cross purposes. Does this mean that the President and Mr. Volcker have reached an unannounced agreement whereby the Fed will accommodate the $98.6 billion dollar deficit projected for this fiscal year and the $91.5 billion dollar deficit projected for FY 83? That is, is the Fed going to permit money to grow more rapidly than its announced target range of 2 1/2 to 5 1/2 percent for M-I would imply?

A. The administration has stated that the Federal Reserve targets for monetary policy for 1982 are consistent with our current projections for economic activity and our fiscal policy assumptions.

## COMMITTEE RECESS

Chairman HATFIELD. The hearing is in recess until 9:30 tomorrow when we will hear from Secretary Regan and Dr. Alice Rivlin.

[Whereupon, at 1:05 p.m., Wednesday, February 24, the committee was recessed to reconvene at 9:30 a.m., Thursday, February 25.]

# ECONOMIC OVERVIEW FOR FISCAL YEAR 1983

THURSDAY, FEBRUARY 25, 1982

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
*Washington, D.C.*

The committee met at 9:39 a.m., in room 1114, Everett McKinley Dirksen Senate Office Building, Hon. Mark O. Hatfield (chairman) presiding.

Present: Senators Hatfield, McClure, Abdnor, Mattingly, Specter, Proxmire, Stennis, Byrd, Hollings, Eagleton, Chiles, Sasser, DeConcini, and Bumpers.

## DEPARTMENT OF THE TREASURY

### SECRETARY OF THE TREASURY

### STATEMENT OF HON. DONALD T. REGAN

### INTRODUCTION OF WITNESSES

Chairman HATFIELD. The hearing will come to order.

Today we resume our economic overview hearings with the testimony of Treasury Secretary Donald Regan.

After Secretary Regan's testimony, we will hear from Dr. Alice Rivlin, Director of the Congressional Budget Office.

Mr. Secretary, it is a pleasure always to welcome you to our committee and to hear from you.

We have a copy of your testimony. You may either summarize or highlight it, if you wish, and we will immediately proceed to hear from you.

### ECONOMIC FAILURES OF PREVIOUS ADMINISTRATIONS

Secretary REGAN. Thank you, Mr. Chairman.

Since the administration's 1983 budget proposal is well known to all of you by now, I thought I would submit my prepared statement for the record and take this time to make some additional remarks.

I realize that this is a difficult time for the economy. No one relishes the thought of Americans out of work. However, in seeking a solution, it is imperative that I point out that the short-run improvisations of past administrations to deal with economic crises have left a legacy of stagflation, failed policies, high interest rates, and inflation.

The previous decade and one-half has seen a series of quick fixes to deal with short-run difficulties. An income tax surcharge was applied at mid-1968. But after the passage of the surtax, fears of "fiscal overkill" floated to the surface and the Federal Reserve lowered the discount rate and pumped up bank credit, only to reverse itself later in the year as inflationary pressures gained in strength.

The recession of 1969–70 ensued and was followed soon thereafter by the ill-fated Nixon price controls of 1971–74. The consequence was an uncertain economic situation. In late 1974 the Ford administration was still fighting inflation with its WIN program while the recession of 1973–75 was well underway. After the recession had largely run its course, fiscal policy was eased in early 1975 and monetary policy shifted to an easier stance. This ushered in the Carter years of high taxes and monetary expansion with their legacy of severe inflationary pressure.

## ECONOMIC PROBLEMS FACING REAGAN ADMINISTRATION

When this administration took office, it inherited a very difficult economic and financial situation. The economy was stagnant and inflationary pressures were strong. Real gross national product had fallen by 0.2 percent in 1980 and the GNP deflator had risen by 9 percent. This only marked the culmination of a process in which real growth had fallen in every year of the Carter administration and the inflation rate had risen.

The Government was locked into a policy of deficit spending, looking to the Federal Reserve for its monetization. The money supply increased at an average 7½ percent annual rate throughout the Carter years compared to an annual average rate of increase of only some 5 percent over the previous 4-year period. By 1980, both real growth and inflation objectives had largely been abandoned in the face of economic stagflation. In a very real sense, economic policy was on automatic pilot, trying to deal with erratic short-term swings but with no clear sense of long-run direction.

Continued policy failures over a 10- to 15-year period has finally led to the incredibly high interest rates and economic disruptions we face today.

## REAGAN ADMINISTRATION PROPOSALS

The Reagan administration resolved to chart a new course. Rather than try to drive the economy with Government spending and money creation, our goal is to restore noninflationary economic growth which produces private sector jobs and income.

Unfortunately, the recession hit before all of our program could be put in place.

The National Bureau of Economic Research dates the beginning of the recession at July 1981. The economy had gone nowhere after early 1979, with real growth stunted, inflation unchecked, and interest rates at very high levels.

The Reagan budget and tax program was signed into law in August and became effective October 1, 1981. Monetary policy was the only part of the Reagan program which did not require legislative action or unavoidable administrative delay. Working with us, the Federal Reserve did not monetize the Carter deficit that it inherited, and slower monetary growth brought down the rate of inflation dramatically.

The CPI has risen at a 5.3-percent annual rate in the last 3 months compared to 8.9 percent for all of 1981 and 12.4 percent in 1980. I might add that the figure which came out this morning at 9 o'clock brings it down to an annual rate of 3½ percent for the month of January. The PPI also has risen at about a 5.3-percent annual rate in the last 3 months compared to 7.2 percent in all of 1981 and 12.4 percent in 1980. The GNP deflator has reacted more sluggishly but there are signs of improvement there as well. The current economic environment poses real policy challenges. In the past, the policy response to a recession has typically taken the form of a series of quick fixes with little concern for their ultimate consequences. It is certainly possible to put together spending programs to help particularly distressed sectors, and a variety of tax measures—touted as "temporary"—could be formulated as well. But none of these will work to overcome the fundamental economic problems which have produced the current recession and which will produce other recessions in the future if not corrected. Our program treats those problems. Our program deals with fundamentals and it will require time to take full effect. The economic difficulties that our program seeks to overcome have required years to develop. There is no overnight solution. If we tinker with the basic thrust of the program, it will never get a chance to work, and we will lapse back into the depressing cycle of low growth and high inflation, that has brought us where we are today.

## CURE FOR DEFICITS

The deficits which we are facing are certainly troublesome. Deficits do matter and they do concern this administration. It is important to realize, however, that the major factor in these deficits is the revenue loss from lower real growth. The fall in receipts of $31 billion in 1982, between our 1981 forecast and the March estimates, is entirely related to economic assumptions.

I might point out that although we face large absolute deficits, mostly due to the recession, CEA and Treasury calculations show that if the economy were operating at a high employment level—5.1 percent unemployment—the deficits produced by our proposed budget would only amount to $11.3 billion in fiscal year 1983 and about $19 billion in fiscal year 1984.

Raising taxes to deal with the deficit would only make the recession worse. Rather than helping the economy and the budget, the higher marginal tax rates that would result from some quick-fix like a surtax or repeal of the individual tax cuts would reduce working, saving, and investment, lower real economic growth, and worsen the budget picture.

Look what happened with the Johnson surtax. Johnson imposed a surtax of 7.5 percent in 1968, 10 percent in 1969, and 2.5 percent in 1970. From late 1969 to late 1970, real GNP declined by 1 percent. Unemployment rose from 3.4 percent in 1969 to 6.1 percent in 1971. A $25 billion deficit in 1968 went to a $3.2 billion surplus in 1969, but by 1971 and 1972 the deficit had jumped back to $23 billion in each year.

For years, we have attempted and failed to balance the budget with higher taxes. We have only succeeded in wrecking the economy.

## BALANCED BUDGET DEPENDS ON IMPROVED ECONOMIC GROWTH

The only real way to balance the budget is through increased economic growth, and increased growth would not be possible with higher marginal tax rates. Tying tax cuts mechanically to economic performance is equally self-defeating. Tax cuts are needed most when the economy is sick. To raise taxes when the economy is healthy would cause a return to lower growth. The last 15 years, of endless experimentation with finetuning of tax and economic policy has clearly shown that the only result is slower growth, higher inflation, and higher interest rates. The time has come to break that dismal sequence. The long-run policies that are now in place will work if they are only left alone.

The recession—itself a legacy from the past—has thrown the budget numbers into heavy deficit. Without the recession, progress toward early budget balance would be clearly apparent. What we face are transitional budget deficits—large in absolute size but not in relation to typical recession experience, such as 1974–75.

This is a critical point for the determination of economic policy. We must not be thrown back into a series of "stop-go" measures. Our long-run course is clearly charted. We must have the good judgment to resolve to stick with current policies. To do otherwise is to insure this committee will be back again this year and next year and every year following—still reacting, still looking for a quick fix to the problems caused by the previous quick fix.

Last year when I appeared before this committee, the challenge before us was inflation. The urgency for action then was no less than today. That threat has abated. But we must not solve this year's challenge with a policy that will result in next year's crisis. This type of patch-quilt economic policy must stop.

In conclusion, Mr. Chairman, I look forward to working with you and with the members of this committee—from both sides of the aisle. This administration achieved last year's success through the help and cooperation of those on the Hill. This year will be no different. I welcome the input of new ideas and suggestions on how we can improve our budget proposals and achieve long-term economic stability.

## PREPARED STATEMENT

I request that the prepared statement which I have submitted to the committee be inserted in the record.

Thank you.

[The statement follows:]

# PREPARED STATEMENT OF HON. DONALD T. REGAN

## SECRETARY OF THE TREASURY

Good morning.

President Reagan's budget is a blueprint for growth and prosperity.

It is a plan for reducing Federal spending and the tax burden.

It is a plan for increasing the family budget.

For the first time, we are asking the right people to tighten their belts: the Federal government.

We have painstakingly gone through every item. All members of the Cabinet have met with the President on their programs. And we have fashioned a budget that responds to the President's call for a new Federalism; it meets the complex needs of our society; and it reduces the rate of growth in government.

This budget contains dramatic reductions in government spending, yet it's important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of common sense to how we spend the people's money.

So let's take a quick look at how this budget was put together.

On the revenue side, we expect receipts totalling $666.1 billion for fiscal year 1983, of which $304.5 billion comes from individuals, $65.3 billion from corporations, $225.5 billion from payroll taxes and the remainder from excises, Federal Reserve earnings, and miscellaneous taxes and fees.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend.

However, the revenue picture has been heavily affected by two factors: the recession and the drop in inflation -- one bitter pill and one piece of candy which together have signficantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth, and divert those resources into government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The first attached chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation and support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the affect of the volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce these unhealthy fluctuations.

The deficits will be manageable because of the growth of private sector saving, as shown in the third chart.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earning induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed tax code without the windfall to the Federal government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not asked for spending restraint of that magnitude, choosing a more gradual path toward budget balance. After a slight dip in real outlays in FY 1983, real outlays are projected to grow approximately one-third as fast as the economy in the following four years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take a billion dollars out of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next five years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher inflation, Federal receipts would be enlarged by $353 billion over the five years as inflation and the progressive tax code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not suprising that some businessmen are holding back until they are certain it is safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investment will be there.

## RECEIPT PROPOSALS

While the Administration is opposed to increasing statutory tax rates -- rates which apply at the margin to taxpayers who work, save, and invest -- at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we will not support increases in marginal rates for taxpayers, we do propose changes in three areas: 1) an elimination of abuses and obselete incentives within the system; 2) a major effort to improve tax collection and enforcement and 3) enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the Accelerated Cost Recovery System (ACRS) and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this Administration, has lowered effective marginal tax rate on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the Administration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable incentive is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements, rather than to all taxpayers engaging in a similar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

This Administration proposes also that Congress join with it in improving tax collection and enforcement. Ensuring that taxes due the government are, in fact, paid by taxpayers and that they are paid on a timely basis is necessary to the maintenance of a fair and workable tax system. If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies upon voluntary compliance. If individuals instead are convinced of the certainty yet fairness of enforcement efforts, and they know that no taxpayer will be given preference in paying tax as income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered. However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then that support will erode.

Strengthened enforcement and improved tax collection are entirely consistent with the Administration's economic program. Improved compliance and timely payment of taxes owed does not raise statutory tax rates and has almost no effect on the rate of return from saving and investment, but it does reduce the opportunities and benefits from underreporting income.

Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis. It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or to pay taxes later than others must.

While this Administration is committed to a program of improved tax collection and enforcement, we are not wedded only to the proposals presented in the budget. We look forward to Congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair to the American people, yet at the same time will address in a forthright manner problems of compliance, administration and timely payment of taxes.

Finally, the Administration has proposed a number of initiatives to improve upon incentives in the economy, to insure that direct beneficiaries and users of various Governmental services are required to pay for some of these services, and to make more rational and consistent the operation of existing programs. While the initiatives involve many issues besides tax policy, I want to discuss them briefly with you today because they also have an effect on receipts.

Shortly we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvements in tax collection and enforcement. We are also preparing legislative drafts which we will send up as soon as they are completed. However, let me now provide you with some brief details on each of our proposals.

## TAX REVISIONS

### Completed Contract Method of Accounting

Current regulations allow contractors to defer tax on income from long-term contracts until the year that the contract is completed. This completed contract method of tax accounting permits full deferral of income reporting on progress payments received by the contractor throughout the term of the contract even though certain costs are currently deducted.

The completed contract method thus permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices. The use of the completed contract method has led to large and unintended tax benefits. For instance, many contractors, including virtually all in the defense and aerospace industries, can substantially reduce their tax liability through the use of the completed contract method. This is accomplished by deferring all income from a contract until the contract is completed while taking allowable deductions for indirect costs currently. In some cases the period of deferral can be as long as 10, 15 or even 20 years.

Because of inflation and the increasing size of new contracts, deductible costs on new contracts often exceed income to be recognized from old contracts in any one year. The result has been that many taxpayers, while enjoying substantial economic profits and reporting these profits to shareholders and creditors, have been reporting large losses for tax purposes. These tax losses may shelter other income from taxation. In at least one case, the losses have been sufficient to eliminate the taxpayer's accumulated earnings and profits, enabling that taxpayer to make tax-free distributions to shareholders.

A particular problem resulting from the long-term contract accounting rules arises because certain construction contracts and contracts for the sale of heavy equipment include provisions for engineering or other assembly services to take place after delivery of parts and materials. Many taxpayers obtain additional deferral by maintaining that contracts are not complete until such services have been rendered. This is done even when full payment has been received upon delivery of parts and materials.

The Administration proposes legislation to disallow the use of the completed contract method of tax accounting, effective January 1, 1983. Taxpayers will be required to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. The percentage of completion method permits current deductions for allowable costs but requires reporting income according to the percentage of the contract completed in the tax year. The progress payment method allocates costs to long-term contracts and defers their deduction until the taxpayer has a right to receive payment under the contract.

At the time the right to payment accrues, the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize such excess as income.

In addition, the Administration intends to amend the current completed contract regulations to require that most indirect costs (so-called period costs) be allocated to contracts rather than immediately expensed, and to clarify current rules regarding when contracts may be aggregated and when they must be severed in order to properly measure income.

The legislative and regulatory proposals would be effective for taxable years beginning after December 31, 1982. However, the legislative proposal provides that taxpayers may continue to use existing completed contract rules for contracts entered into on or before September 25, 1981, the date the Administration first announced its intention to change these rules. The regulatory proposal will similarly grandfather contracts entered into on or before September 25, 1981. Grandfathered contracts, however, may be affected by our corporate minimum tax as discussed below.

Repeal Business Energy Tax Credits

Under current law, businesses are allowed investment tax credits for energy property in addition to the regular investment tax credit. Also available are production tax credits and Industrial Development bond financing for certain energy sources. Current law further provides an excise tax exemption, or an equivalent tax credit, for gasohol. Some of these energy tax incentives expire at the end of 1982, but others extend through 1985 and beyond.

The original reasons for providing these tax incentives no longer apply today. At the time these incentives were proposed and enacted, price controls and allocations were in effect on both crude oil and natural gas, and there was substantial political resistance to decontrol. Prices of both oil and natural gas faced by consumers and received by producers were substantially below replacement costs, as reflected by the price of imported oil. Oil imports were growing at the same time that domestic consumption was being subsidized and domestic production discouraged.

Because of price controls, business firms and households had insufficient incentive to invest in energy-conserving capital or in alternative energy sources (other than oil or gas), or to use alternative fuels, such as fuels derived from alcohol, wood, or biomass. Therefore, some economic rationale may have existed for tax incentives for conservation and renewable energy.

Since enactment of the credits, however, crude oil prices have been decontrolled and partial decontrol of natural gas prices is being phased in. Whatever their original justification, the credits are no longer needed because most firms confront the true replacement cost of energy and therefore have sufficient incentive to invest in energy conservation and renewable energy and to purchase alternative fuels without targeted tax incentives.

The energy tax incentives distort the allocation of resources by encouraging firms to undertake investments that are uneconomic at current market prices and to purchase higher cost fuels when a lower cost substitute is available. As a result, these incentives divert workers, capital, and initiative from more productive uses elsewhere in the economy and lower the net productivity of the capital stock.

In general, tax incentives for specific investments fail to rely on markets to allocate resources efficiently. We believe that it is better to rely on the market, rather than Federal management, to determine patterns of energy use. The Administration's Accelerated Cost Recovery System (ACRS), enacted as part of the Economic Recovery Tax Act, has removed tax impediments to business investment -- including investments now eligible for energy tax incentives -- without dictating firms' choices among investment alternatives.

Moreover, by reducing the cost of only some conservation measures, the energy tax incentives discourage other, potentially more efficient, approaches. Many new inventions and refinements in old technology are not covered by the subsidies, and therefore are at a disadvantage because the Federal government subsidizes the competition.

Effective January 1, 1983, the Administration proposes to repeal all business energy tax credits, the gasahol excise tax exemption, and special provisions allowing States and localities to issue tax-exempt industrial development bonds to finance low-head hydroelectric facilities and other energy property. Fuel production credits and incentives for alcohol fuel production will also be repealed. Transition rules will mitigate the effect of repeal on taxpayers who have relied on existing law.

## Restrict Tax-exempt Bonds for Private Activities

Current law permits States and localities to issue tax-exempt revenue bonds for industrial development, housing, and other private activities. There is no requirement under current law that industrial development bonds (IDBs) serve a genuine public purpose. In addition, tax-exempt financing, combined with Accelerated Cost Recovery and the investment tax credit, can result in unwarranted tax benefits.

The volume of private purpose tax-exempt bonds has grown rapidly. More than $25 billion were issued in 1981, up from $8.5 billion five years earlier. Private purpose bonds accounted for 24 percent of the tax-exempt bond market in 1976 but rose to 48 percent in 1981. The largest growth has occurred in small-issue IDBs, which allow tax-exempt financing for any trade or business. Small-issue IDBs marketed in 1981 reached an estimated $10.5 billion, out of the total $25 billion of private purpose bonds. Continued growth in the use of tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. The expansion of tax-exempt bonds for private purposes affects the market for tax-exempt securities as a whole. This raises the cost to State and local governments of financing traditional public services.

Many of the private activities using tax-exempt financing would not have received direct Federal or local government assistance. Small-issue IDBs have been used to finance such private activities as office buildings for doctors and lawyers, fast food franchises, recreational facilities, and nursing homes operated for profit. Access to tax-exempt financing is offered in almost all political jurisdictions, either by State or local governments or by authorities acting on their behalf. These authorities are often established for the sole purpose of issuing tax-exempt revenue bonds for private entities and may serve to avoid local voter approval requirements.

Providing tax exemption for the interest on certain private purpose obligations may serve legitimate public purposes in some instances. Current law, however, does not require the showing of any genuine local public purpose. In fact, several issuing authorities have authorized tax-exempt bonds for facilities located outside of their own jurisdiction. A requirement that private purpose tax-exempt obligations be shown to serve the needs of the local community will improve the uses of the Federal tax benefit and will limit the volume of such obligations. This will reduce their impact on the market for traditional municipal bonds and the Federal government's revenue loss.

The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of capital resources. The ability to obtain a lower cost of borrowing for certain activities creates a bias in favor of investment in those activities. In effect, those favored activities are subsidized at the expense of other activities. Thus, the allocation of capital is based upon government decisions rather than upon its relative economic productivity.

Moreover, in combination with the accelerated cost recovery provided investment by the Economic Recovery Tax Act, tax-exempt financing results in unwarranted subsidy for many eligible borrowers. This combination of tax benefits completely eliminates the tax on income from certain investments and also provides tax shelter for income from other assets. "Double dipping" of this sort should not be allowed.

In contrast with other categories of private purpose tax-exempt bonds, exempt small issues may be used in limited dollar amounts for any type of investment in depreciable property or land. Large businesses presently are able to finance an unlimited number of facilities with small-issue IDB's because the dollar limits apply only within a single city or county. For example, one of the largest chains of retail stores in the country, has financed facilities in at least 100 localities, to the tune of $240 million since 1976. Many large firms are using small-issue IDB's even though they are able to raise ~~funds readily in capital markets without a~~ government subsidy or guarantee.

The Administration proposes that assets financed with tax-exempt bonds issued after 1982 must be depreciated using the straight-line method over extended recovery periods. In addition, the tax exemption for private purpose bonds will be limited to those that are publicly approved by State or local governments and which, for bonds issued after 1985, receive a financial contribution or commitment from the local government. Small issue industrial development bonds will not be allowed for large businesses, which have capital expenditures exceeding $20 million over a six-year period. Additional requirements relating to information reporting of IDBs, registration, and arbitrage profits also will be imposed.

## Modified Coinsurance

Many insurance companies have entered into modified coinsurance arrangements and have claimed substantial reductions in their tax liability. Such arrangements are designed principally for tax avoidance since little, if any, insurance risk is actually transferred between companies.

In form, modified coinsurance agreements involve the transfer of insurance risk between two companies. In substance, virtually no insurance risk is actually transferred. Although together they may be in the same financial and risk position after the transfer, their combined taxes are lowered substantially. Many policies reinsured under modified coinsurance involve little, if any, present insurance risk. Because there is no meaningful transfer of risk, there is generally no significant non-tax business purposes for most modified coinsurance agreements.

Modified coinsurance agrements are structured so that actual payment between the companies is a small percentage of the amount of income converted. This small charge represents the "coinsurer's" fee for entering into the agreement. The nominal amount charged indicates the absence of any significant transfer of risk or economic purpose under the modified coinsurance agreement.

The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The federal corporate income paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance. In several cases, the effect was to nearly eliminate tax liability.

Through regulations and legislation the Administration proposes to eliminate ~~the unintended tax benefits resulting~~ from the use of modified coinsurance. In addition, the tax treatment of other forms of coinsurance will be changed to prevent insurance companies from obtaining similar unintended tax benefits. The legislative proposal applies to all reinsurance agreements entered into after December 31, 1981.

## Capitalization of Construction Period Interest and Taxes

Individual taxpayers must capitalize interest and taxes incurred during the construction of commercial and industrial buildings and deduct those costs over ten years. Under provisions of the Tax Reform Act of 1976, the write-off period for rental housing (other than low-income housing) is 8 years, but is scheduled to become 10 years by 1984. However, for corporations (other than subchapter S corporations and personal holding companies), the law permits immediate write-off of these costs. The substantial acceleration of cost recovery provided by the Economic Recovery Tax Act of 1981 makes it unnecessary to grant corporations an immediate deduction for a portion of construction costs.

It is a well-established financial and tax accounting principle that the costs of acquiring an asset, whether it is held for resale or for use in the production of goods and services for future sale, should be considered a capital cost, not a current cost, of earning income. Only when the asset itself is sold may the capitalized cost be recovered as a deduction from the sales proceeds in determining gain; or, if the asset is used by the owner to produce goods and services for sale, the capitalized cost may be recovered as deductions over a reasonable period as the asset is used.

Unlike most corporate taxpayers, individuals and partnerships are required to capitalize construction period interest and taxes other than those associated with low-income housing. These costs of acquiring assets are like other construction costs such as labor, materials, fees, and permits, all of which are capitalized and recovered when the real estate is sold or used to produce income. There is no economic policy or tax administration reason why corporations should not be subject to the same rules as individual taxpayers who construct commercial and other nonresidential buildings. Indeed, it is both economically inefficient and unfair to apply different sets of accounting rules to taxpayers according to their form of organization.

The Administration proposes that construction period interest and taxes incurred by corporations to develop non-residential real property after December 31, 1982 be capitalized. Costs will be recovered over 10 years. This proposal will not change the tax treatment of residential construction. The cost of commercial construction undertaken by corporations will be increased by a small amount, normally less than 2 percent.

## Corporate Minimum Tax

Corporations currently must pay a minimum tax, in addition to regular income tax, equal to 15 percent of certain tax preferences. This "add-on" minimum tax is not limited to those corporations that pay very little or no regular income tax. It may apply to any corporation that has reduced its tax liability through the use of designated tax preferences.

Nonetheless, many corporations currently pay no Federal corporation income tax, despite reporting large profits to their shareholders. The proposed corporate minimum tax would tax "corporate profits," that is, regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax.

For corporations other than Subchapter S corporations and personal holding companies, the Administration proposes to repeal the add-on minimum tax, effective January 1, 1983, and to replace it with an alternative minimum tax. Corporations will be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base. This alternative tax base equals regular taxable income plus certain tax preferences, less $50,000. The alternative tax base will include both preferences from the current minimum tax and a number of new preference items. Current preference items also in the alternative base are:

- Percentage depletion in excess of the year-end adjusted basis of the property,
- Accelerated depreciation on real property in excess of that allowable under the 15-year straight-line method,
- Amortization of certified pollution control facilities, and child care in excess of normally allowable depreciation, and

- Reserves for losses on bad debts of financial institutions in excess of reserves allowable on the basis of their experience.

The alternative base will also include the following new preference items:

- Intangible drilling costs in excess of amounts allowable had they been amortized over 10 years,
- Mining exploration and development costs in excess of those allowable under a 10-year amortization schedule,
- Lessor's leasing benefits which are in excess of net cash investment amortized on the straight-line basis over the term of a safe-harbor lease,
- Deductions for interest on debt to carry tax-exempt securities,
- Deferred DISC income,
- Shipping income deposited in capital construction funds or construction reserve funds,
- Amortization of motor carrier operating rights deductible under Section 266 of the Economic Recovery Tax Act of 1981,
- Original issue discount interest deductions in excess of amounts that would be deductible under a constant interest rate bond, and
- Current deductions of certain indirect costs incurred with respect to long-term contracts entered into before September 25, 1981.

The foreign tax credit is the only existing credit claimable against the alternative minimum tax. Investment tax credits which give no benefit due to the minimum tax can be carried forward.

We look forward to working with this Committee to develop a base for the corporate minimum tax that is reasonable and fair, yet insures that all profitable corporations pay their share of tax.

## IMPROVED TAX COLLECTION AND ENFORCEMENT

### Withholding on Interest and Dividends

Individuals who honestly report their interest and dividends pay more than their fair share of the total tax burden. Recovering known lost tax revenues by withholding -- where a reporting system is already largely in place -- is both an efficient and a sensible step to take.

Imposition of withholding on interest and dividends is a natural complement to the Economic Recovery Tax Act objective of reducing the tax burden on income from investment. Withholding offers an ~~opportunity to increase tax revenues~~ substantially without raising taxes on those citizens who carry their full share of the tax burden of this country.

While individuals are estimated to underreport wage income by only 2 to 3 percent, the comparable figure for interest and dividend income is 9 to 16 percent. Even with the additional reporting requirements enacted in the Revenue Act of 1962, a number of taxpayers still fail to report and pay tax on around $20 billion of taxable dividends and interest.

As interest and dividends have increased as a share of individual incomes, the compliance problems of underreporting has also increased. In 1962, interest and dividends represented approximately 5.3 percent of adjusted gross income; by 1981, interest and dividends represented 8.4 percent of reported adjusted gross income -- an increase from $40 billion to $150 billion. At the same time, the portion of individuals' income represented by wages declined by at least an equivalent amount. As a result of this change in the composition of the Nation's income, taxpayer compliance overall has declined because a smaller portion of overall income is subject to withholding.

Unfortunately, information reporting is simply inadequate to reduce this shortfall. Much of the unreported interest and dividend income consists of relatively small amounts that millions of taxpayers simply neglect to report -- as a result of failure to maintain records, or other causes not amounting to fraud. Although the IRS matches a high proportion of the information returns filed, there are a number of reasons why the matching process cannot close the gap of unreported income. Many information returns contain inadequate or inaccurate information, with the result that matching is difficult or impossible. In the wage area, by contrast, the number of unprocessable information returns is much lower because taxpayers have an incentive to obtain proper credit for withheld taxes. It is extremely expensive for the IRS to use letters, phone calls, and personal visits to follow up taxpayers suspected of underreporting, especially when only small amounts of tax may be collected from each one.

The obvious failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system, and jeopardizes our system of voluntary compliance. Moreover, past experience has proven that withholding is by far the most effective means of combatting noncompliance in the reporting of income.

Under the proposal, 5 percent of payments of taxable interest and dividends would be withheld. Nontaxable individuals filing exemption certificates and corporations would be exempt ~~from withholding. Taxpayers aged 65 or~~ older with a tax liability of $500 ($1,000 on a joint return) or less would also be exempt from withholding. This will exempt elderly couples earning less than $14,907 in 1983.

This withholding proposal differs significantly from past withholding proposals. The problem of forced overwithholding, so prevalent in those past proposals, has been virtually eliminated by the low rate of withholding, the proposed exemption procedures, and the provision in ERTA which will allow workers to adjust wage withholding for any overwithholding that could occur. In addition, we must recognize that the system of reporting of interest and dividend income on forms 1099 is well established; new forms will be quite similar to the old forms, with an additional line for the amount of tax withheld. Costs to financial institutions thereby will be kept to a minimum. Indeed, my own experience as head of a large financial organization, along with many discussions with officers of our Nation's financial institutions, has convinced me that withholding is a sound and efficient means of increasing compliance.

## Corporate Income Tax Payment Speedup

Corporations generally are required to pay at least 80 percent of their current year's tax liability in estimated payments due four times a year. The remaining liability is payable in two equal installments due on the 15th day of the 3rd and 6th months following the close of their taxable year. An exception to the estimated tax payments rules permits corporations to base their estimated tax payments on the full amount of their prior year's tax liability. For large corporations, the estimated payments must be at least 65 percent of their current year's liability (75 percent in 1983 and 80 percent thereafter).

To the extent feasible, taxes should be paid on a current basis. Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent. A 10 percent deviation is sufficient to reflect the uncertainties of intra-year estimates.

In order to collect corporate taxes on a more current basis, the Administration proposes, for tax years beginning after 1982, to increase the required estimated tax payment from 80 percent to 90 percent of the current year's liability, and to require that all remaining liability be paid in one payment on the 15th day of the 3rd month following the close of the tax year. In addition, large corporations making estimated tax payments based on prior year's liability will be required to pay at least 85 percent of their current year's liability in 1985 and 90 percent thereafter. All corporations with taxable incomes of less than $1 million in each of the three prior years will be exempt from this latter rule.

## IRS Staff Increases

In order to improve the efficiency of enforcement and collection activities, the Administration proposes to increase the enforcement staff of the Internal Revenue Service by more than 5,000 persons.

Three thousand of these 5,000 new employees will be assigned to collecting delinquent taxes, 1,000 will concentrate on the identification of nonfilers who owe tax, and the remaining 1,000 will examine deficient returns and process appeals.

Although the vast majority of taxpayers voluntarily pay their correct tax on time, delinquent taxpayers currently owe the Treasury more than $20 billion in uncollected taxes. An estimated additional $70 billion in revenues are lost each year as a result of unreported income and improper deductions. A strengthening of Internal Revenue Service enforcement activities will generate increased government revenue and will improve the fairness of the tax system for all taxpayers. Public confidence in the equity of our tax laws is preserved only if the few who fail to pay their fair share are held accountable.

## OTHER PROPOSALS AFFECTING RECEIPTS

### Enterprise Zone Tax Incentives

Under current law, no special tax incentives are provided for the redevelopment of depressed areas. The Administration therefore proposes that beginning January 1, 1984, up to 25 small urban areas per year (not to exceed 75 in total) may be designated as "enterprise zones". Relief from Federal, State or local regulations, and special tax incentives designed to increase investment and employment will be provided businesses and individuals locating in these areas. These incentives will be applicable for a 20-year period. The Administration will be providing you with details on this proposal at a later date.

### Miscellaneous Proposals

- Airport and airway trust fund taxes. Statutory authority for the airport and airway trust fund expired on September 30, 1980. The Administration proposes to reinstate statutory authority for the airport and airway trust fund effective July 1, 1982.

- Increases in passport and visa fees. The Administration has proposed an increase in passport fees from $15 to $30 effective April 1, 1982, and an increase in immigrant visa fees from $25 to $100 effective March 1, 1982.

- Change in railroad retirement system. The railroad retirement system provides coverage generally equivalent to a combination of social security and a multi-employer industry pension plan. Railroad employees and employers make contributions to railroad retirement that are generally equivalent to social security payroll taxes. Beginning October 1, 1982, the Administration proposes to extend full social security coverage to railroad workers; payroll taxes would be deposited directly in the social security trust funds. The Administration also proposes to return the rail industry's plan to the private sector.

- Extension of highway trust fund taxes. Under current law, the 4 cents per gallon tax on gasoline and diesel fuels will decline to 1.5 cents per gallon on October 1, 1984. Several other taxes that are deposited in the highway trust fund will be reduced or will expire at the same time. The Administration proposes to extend these taxes at their present rate.

- Extension of social security hospital insurance taxes to Federal employees. Most Federal civilian employees currently are exempt from social security taxes. The Administration proposes to require Federal employees to pay the employee portion of the social security hospital insurance tax effective January 1, 1983.

### Technical Proposals

As soon as possible technical proposals will be submitted to further close tax loopholes and facilitate IRS collection and enforcement efforts.

## CONCLUSION

We have in place a tax system for the 1980's that will promote the growth of income, savings, investment and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past -- policies that have been tried and failed.

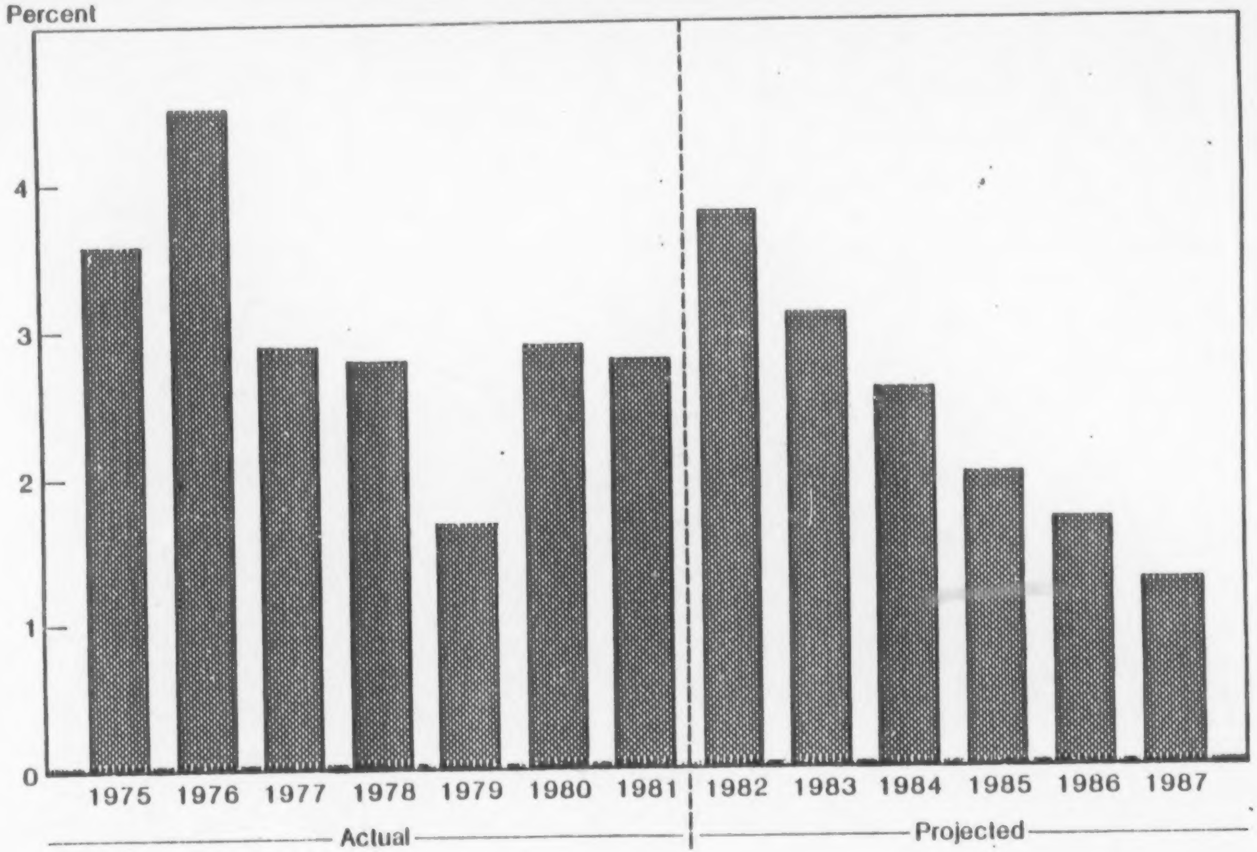
The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

While the Administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me throw out a final challenge to those who might oppose the Administration's tax program. I recognize that there are those who did not and do not support reductions in rates of tax for individuals and businesses, and I recognize that there are those who will oppose the initiatives that we have presented to you today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs. This type of choice, however, favors "special interests", those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis and users of services who do not pay for the benefits that they receive. Such favoritism is not warranted for two reasons: first, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden, and, second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

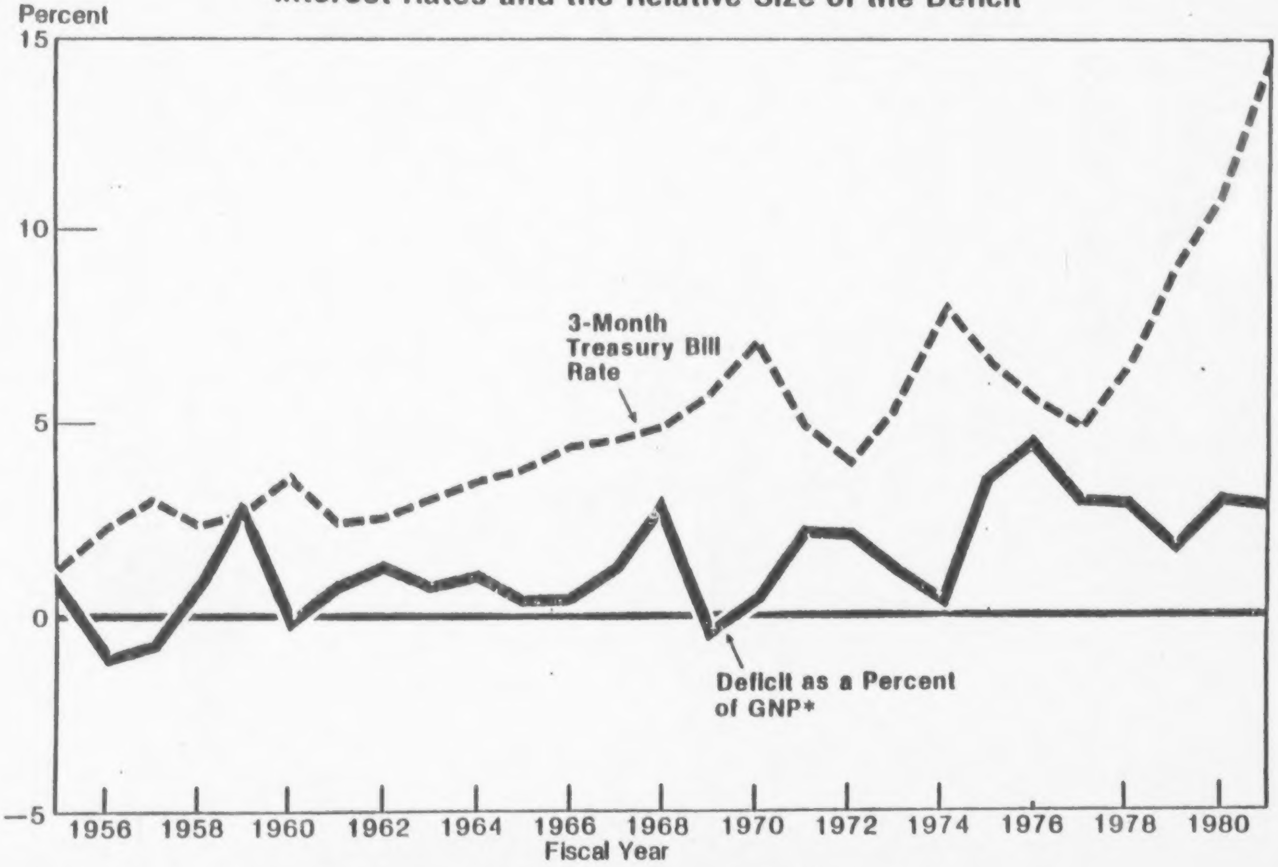
Mr. Chairman, I do not believe that most members of this Committee will favor special interests over the average taxpayer. I invite each member of this Committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives and to charge users of various Federal programs for the benefits that they receive.

## Budget Deficits in Relation to GNP*



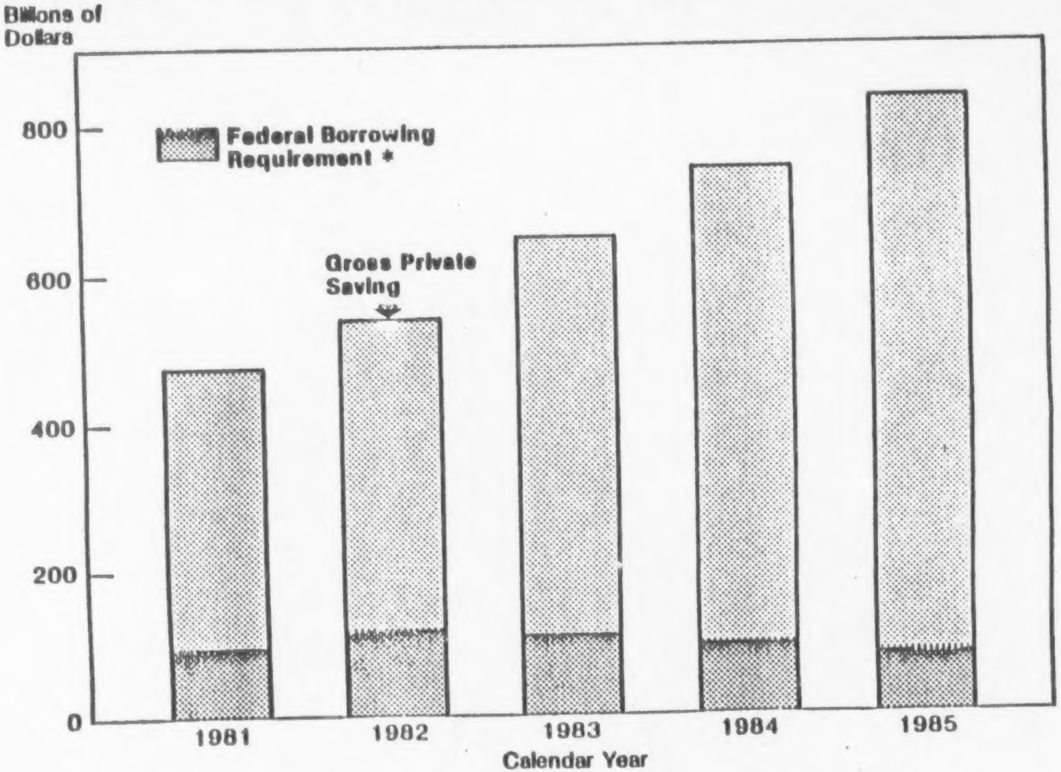
* On and off budget as percent of fiscal year GNP.

Interest Rates and the Relative Size of the Deficit



* Federal surplus or deficit includes off-budget items. Points below zero line represent surplus as percent of GNP, points above line a deficit.

Projected Borrowing Requirement in Relation to Private Saving



* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

## RISE IN INTEREST RATES

Chairman HATFIELD. Thank you, Mr. Secretary.

We will proceed with the system we used yesterday of having a 5-minute round of questions so that everyone can have a chance to ask you questions.

Mr. Secretary, you stated that interest rates do not parallel the Federal deficit but rather follow inflation. With the fall in inflation, how do you explain the rise in interest rates since mid-December, and isn't this evidence that interest rates do relate to the Federal deficit?

Secretary REGAN. Mr. Chairman, the rise in interest rates that happened in January of this year, I think is solely due to monetary concerns, rather than to fiscal concerns. In November and December of last year, the money supply rose dramatically. M–1, in particular, grew at a 13-percent annual rate. That was followed in January, with a spike, a 20-percent increase in the rate of monetary growth of M–1 during that month alone. That is a very unusual rise in money growth.

As a result, money markets quite properly thought that the Fed would, as the Fed did, start to tighten up on money. The market anticipated that tight money would cause higher rates of interest and immediately interest rates shot up.

You can see this in the diagram. Looking at the money supply and then looking at interest rates, you can see that hook coming right at the end as interest rates were coming down with the money supply, but as soon as the money supply shot up, interest rates came up with it.

## CONSISTENCY BETWEEN BUDGETARY AND MONETARY POLICY

Chairman HATFIELD. This raises an interesting question. As you know, Mr. Volcker has attributed high interest rates to prospective budget deficits stating that financial markets have been frightened by that prospective, increased deficit.

So my question, then, would be, how do you achieve consistency between budgetary policy and monetary policy?

Secretary REGAN. The Chairman, Mr. Volcker, is quite correct in saying that the money markets are frightened by the high deficits forecast by this administration and the forecast of others that they will be higher than we have projected.

There are several causes of why interest rates in the money markets are high. And in the answer I gave you in the first question, I was merely referring to that peculiar rise in the money volume in the November, December, January period. Overall, I would agree with Chairman Volcker, there are several causes not the least of which is the deficit, and crowding out by the deficits.

It is not the deficits themselves but the fact that we at Treasury will have to raise this money and there might be crowding out and we would use up more of the pool of savings than the business community would like.

Chairman HATFIELD. Let me approach it from another angle.

### CONTRADICTION IN FISCAL POLICY

As I hear your statement of fiscal policy, it is basically expansive, you said growth is a key to the balancing of the budget, whereas monetary policy is antigrowth. This seems to me to be a contradiction which has had obviously, at least to my way of thinking, an impact upon the punishing interest rates that we have experienced in the present recession.

Do you think this is an accurate assessment of the contradiction or the apparent contradiction?

Secretary REGAN. What we have asked of the Federal Reserve, and they seemed to have agreed in their policy statements, is not what would be characterized as a tight money policy. We have asked for slow growth in the money supply, not no-growth, and not, certainly, a negative growth. Their target this year, again, speaking of M–1, is 2½ to 5½ percent. We have asked, particularly, as we come out of this recession, that they keep that growth rate in the upper part of their range, around the 5, 5½ percent area until we are out of this recession.

I think if they stick on that, that is about 5 percent growth in the money supply, that is not a tight money policy as one would normally construe it.

What was really tight money was April to October 1981, when the growth rate was less than 1 percent; that is tight money.

We are not asking for that.

At the same time, we think we can achieve an appreciable growth rate coming out of this recession.

Our projections are below the average for all of the post World War II recessions. The average is 6.9 percent coming out in the first four quarters.

We are projecting 4.5 percent. So if we have 4.5 percent real growth in those four quarters, with the 5 percent increase in the money supply, we think we will get the stimulation this economy needs.

### CORPORATION INVESTMENT IN OTHER BUSINESSES

Chairman HATFIELD. Why are so many cash-rich firms choosing to buy up other firms rather than undertaking expansion on their own? What is the net investment brought about by this?

Secretary REGAN. I will try to keep the answer short.

Much of it involves psychology as well as finance and economics. The ego of the CEO, has to be examined to see whether he wants to continue to expand his power and the areas over which he has command. That is the conglomerate approach.

From the point of view of growing large, there are many who want vertical integration so they will buy companies that fit in with what they are doing.

Others want to diversify to get out of the particular line they are in, therefore a steel company buys an oil company. There are many reasons why these companies are buying out, not the least of which is to keep earnings going up annually year after year.

That is the game.

Chairman HATFIELD. It does not help the crowding out problem.

Secretary REGAN. To the extent that it might crowd out that is possible. But it all depends upon where the money is coming from. If it is a cash-rich company, as you designated, and the company has the cash, that has no effect on crowding out.

To the extent that one company might have to borrow the entire amount to buy, that might induce some crowding out of other credit demands.

Chairman HATFIELD. Thank you.

Senator Proxmire?

### ADMINISTRATION-PROPOSED DEFICITS

Senator PROXMIRE. Mr. Secretary, I am surprised that you say that the rise in interest rates since December is solely the result of monetary concerns. Certainly that was an element, but it seems to me it was a relatively minor element.

The financial community, as you know better than I, is sophisticated. It has seen these fluctuations from time to time. It knows that a quarterly fluctuation is not unusual. At the same time the financial community must have been shocked to see this administration, which last year more than any administration I can ever recall address the very serious problems of deficits, come forward and propose these perfectly colossal deficits.

When you appeared before us last year you said, "I don't think we can sustain $60 or $70 billion deficits year after year without ruining the country." The average budget deficit over the 5-year period ending in fiscal year 1985 will be not $60 or $70 billion but $82 billion and many people feel that you are being extremely optimistic in holding it down to $82 billion.

Don't you feel that the Chairman's point that deficits play a part, even in the most recent rise in interest rates, has some merit?

Secretary REGAN. You will recall that interest rates started up in November, increased in December and then shot up the first part of January. We didn't reveal our budget figures until late in January after the Congress returned. So the knowledge of our deficit figures would not have permeated, although I admit there were leaks.

Senator PROXMIRE. There sure were.

Secretary REGAN. All over the place.

Senator PROXMIRE. We knew about it and the financial community knew about it. It wasn't a secret.

### INABILITY TO CUT BUDGET IN SPECIFIC AREAS

Secretary REGAN. There were a lot of guesses. There were guesses that we might come in with budget deficits as high as $150 or $160 billion. We didn't. So the financial community did have that leak. I would be unable to say how much faith they were putting in leaks versus the document, but I do agree with you that it was a shock to the community when we came in with our $91, $82, $70 billion deficits.

Let me explain what happened here, Senator, if I can.

We are faced here with a recession. We are faced here with an inability to cut spending in certain areas.

Senator PROXMIRE. Inability to what?

Secretary REGAN. Cut budget in certain areas from our point of view, defense being one, social security another.

Obviously you can't cut interest on the debt until interest rates themselves have come down. So therefore you have 33 percent of the budget left. When you get through we have made suggested cuts of $30 to $35 billion in what is remaining other than those three items in the budget. You then have the problem of the deficit, how do you attack the deficit?

You can do it either by taxing citizens and getting money that way, either corporate citizens or individuals, or you can borrow the money. Now after careful thought going up one side, down the other we came down on the side let's go with the deficit and borrow the money rather than to tax the money away and destroy the incentives.

Senator PROXMIRE. The difficulty is that when you look at the outyears, even accepting your optimistic assumption that unemployment will be reduced pretty sharply, you still have deficits of $82.9 billion in 1983, $71.9 billion in 1984 and so forth. These are very high deficits assuming that we are going to be in a period of relative stability and prosperity.

Secretary REGAN. Let me caution you, Senator. I know from your own background you hardly need this advice from me, it would seem gratuitous. As you go out into those years and get, 3, 4, 5 years out from now, the validity of those projections is less and less the further you go out.

### REAL GROWTH PROJECTIONS

Senator PROXMIRE. It is indeed, but the difficulty is, as I say, that these are optimistic projections. I don't know anybody who would be more optimistic than you are, experts from the private sector or the Congressional Budget Office or anywhere else who are projecting real growth for the next year and a half of 8.2 percent.

Let's compare that estimate with the same six initial recovery quarters coming out of the 1975–76 recession. The difference is that when we were coming out of those recessions, we didn't have housing and automobiles in the terrible position they probably will remain in because of the very great likelihood we are going to have high interest rates for a long time.

These are credit sensitive industries and they are the core, the heart, of the recession.

Secretary REGAN. Is the bottle half full or half empty?

Chairman HATFIELD. Thank you, Senator.

Senator McClure.

## SPENDING PATTERNS A PRODUCT OF PAST CONGRESSES

Senator McCLURE. Mr. Secretary, I think it is worth noting again for the record, the shock and dismay felt by many people at what the budget deficit projected, but that is the result of past spending patterns established in this Congress and by many of the people present over a good many years. This administration didn't create those spending patterns and this administration can't break those spending patterns, they are the product of the Congress and the solution will lie in the Congress. Let's get that context squarely at the beginning.

But I am a little concerned about one theme that I begin to hear iterated and reiterated in the administration. I was talking to one of your compatriots on Wall Street and he said interest rates are going to come down. I said "Good, I am glad to hear it. Are you confident they are going to come down?" He said: "Yes, absolutely."

"Then I expect you are investing in the long-term bond market, aren't you?" He hesitated a moment and he said, "No." I said, "Why not. We just haven't."

"Why not if you believe interest rates are going to come down? Why are you still borrowing short?" He said, "Senator, we have been burned."

What is it that burned them? It was congressional actions, Federal Government actions that kept deficits high and drove the rate of inflation higher, is that not correct?

Secretary REGAN. That is very true, Senator.

## CAUSES OF INCREASED INTEREST RATES

Senator McCLURE. If that is correct, then deficits do cause interest rates because the expectation of money managers that Congress will not do what Congress has to do, that deficits will remain high, that there will be all of the associated phenomena with increasing national debt, crowding out inflationary pressure, all the rest and they are betting on that happening, is that not correct?

Secretary REGAN. That, plus monetary policy. As I said in answer to Senator Proxmire, it is very hard to put a percentage on this, the 60 percent deficit and 40 percent monetary policy, is it 70 percent monetary policy and 30 percent deficit. But the twin fears are there.

Senator McCLURE. I understand that. There is a risk premium, that has been mentioned by Dr. Weidenbaum. I suspect that there is, very high risk premium. I will tell you, the American public is getting very unhappy about these high interest rates. They are killing us. The talk around these halls, I don't suspect it is talked around the halls of the administration, but the talk around these halls, is about credit allocation, credit controls, interest rate controls, windfall profits, tax on excessive interest rates, penalty treatment on the monetary market. I hope somewhere the people in Wall Street begin to recognize there is another risk premium that may be assessed.

There is also the beginning of the talk around these halls that there is a degree of greed in the money market. One of my colleagues talks about interest rate junkies, people that got hooked on high interest rates and they are going to keep them as high as long as they can in spite of what that does to our recovery.

I would reiterate what has been said here before. The greatest savings we can make in the budget deficit this year will probably be in getting interest rates down and reducing the cost of service of the national debt.

Secretary REGAN. I agree with that. I think that if the Congress performs that way, I am sure the Fed will take heart and I will assure you that this administration would go along with the efforts of the Congress. The President has openly said that he will welcome discussion with the Congress about further budget cuts.

As far as the interest rates and the unusual premium, I think that will fast disappear as the inflation rate starts to abate. We have had over the last 10 days quite a drop in the money markets except in the prime rate. For example, just 10 days ago for 30-year treasuries, the yield was somewhere in the neighborhood of 14.75 percent, it is now down to 13½ percent. There has been that much of a drop in 10 days.

Senator McCLURE. If the money market really believes that inflation was going to be controlled and that interest rates would be dropping, wouldn't they be buying those 30-year bonds at that rate, 30-year treasuries?

Secretary REGAN. I would assume so. Somebody has been buying them. That is why they have come from 14.75 to 13.50 percent.

Senator McCLURE. I think volume would be high if they have any confidence. I can't fault them if they don't have confidence in the Congress. Our track record has been pretty abysmal.

### INCREASE IN PRIVATE SAVINGS

I want to refer to one thing. On page 3 of your statement you say this:

> Private saving resulting from the normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal Government in 1983 and 1984 and thereafter.

Don't you mean total additional borrowing?

Secretary REGAN. Yes; I do.

Senator McCLURE. I was amazed indeed that we would have total savings so dramatically increased that we cover the $1 trillion deficit as well as the additional Federal deficit.

Secretary REGAN. You are absolutely correct, that is additional borrowing.

Senator McCLURE. Thank you.

Chairman HATFIELD. Thank you.

Senator Stennis.

### INTEREST RATE PROBLEMS

Senator STENNIS. Mr. Chairman, I want to commend the Secretary for the fine work and the contribution that I think he has made in these troublesome times since he became a member of the Cabinet. We have some members of this committee that are knowledgeable in the field of economics; I am not one of them. I try to be a realist. I have been in 77 counties out of 82 in my home State within the last 80 or 85 days, courthouses, newspaper offices, court squares, bankers, businessmen and it doesn't take an expert to know that the trouble is with the interest rate—the high interest rate—and the people are sold on that and sold by the President of the United States, Mr. Reagan.

Now, they asked me what am I going to do about it. I was fishing in that pond a year ago in January. I asked you about these interest rates. Just refreshing your recollection, you said "Well, give us, the administration, a chance, and it will come down." You were so honest about that.

## METHODS PROPOSED IN REDUCING INTEREST RATES

Incidentally, let me commend you and Mr. Volcker; apparently you are still on speaking terms and apparently you really cooperated, or tried to, through these months and that is better than we have had at times in the past, as I see it; but the fact that it perplexes both of you rather completely, it is kind of frightening to me.

To drive us all back to this practical matter, what are we going to do to get these interest rates down?

We are becoming paralyzed down home, stagnated or whatever you might call it, the communities; large, small, and all the in between, suffering about the same fate.

## UNEMPLOYMENT RATES

I think we have the highest rate now of unemployment. I believe it is the highest since the big depression. Something has to give somewhere, Mr. Secretary. I am not blaming you for failing to deliver these interest rates as you predicted a year ago but what are we going to do now? When this budget figure came out, as I see it with a deficit of $91.5 billion, you gentlemen could have gone back for a second, look and see if you couldn't bring it down to a lesser figure than that considerably.

## POSSIBLE DEFENSE CUTS

I am promilitary but my suggestion is take another look at those military figures. I believe you can make and use discretion and judgment—that you can make some reductions there. I would rather you make them than for me to try to make them—the military and the Secretary and Defense, you and others, the President, but I think this Congress is going to do something about these matters. They don't want to close the books for this much of an increase.

The people don't like it at all. They are convinced now there has to be more of a closing of that gap to get these interest rates more controllable and that is the only way out. I am not just popping off. But I think an across-the-board reduction of some kind would work now to get this thing more in line.

To sum up—you gave good, strong assurance last year—what do you sum up now? What are you putting your hope on now to get this thing in better shape? What are you going to do besides this budget?

### REDUCTION OF PRIME RATE

Secretary REGAN. Well, Senator, if you recall when I spoke before you this time last year, the prime rate then was somewhere in the neighborhood of 20–21 percent; it did come down to 15¾ percent by yearend and we had this unfortunate runup of the last several weeks which I think is a temporary phenomenon as we wash this excess burst of money through the economy.

I think that interest rates will again start down. As I have suggested, in the last 10 days they already have started slightly—not enough certainly—but I think they are starting down and will continue to come down—not falling like a stone, but gradually coming down over the years.

### REAL GROWTH INCREASE IN SECOND QUARTER OF 1982

We are predicting that the second calendar quarter of 1982 will be a plus quarter as far as real growth is concerned. If that proves to be correct and if we are emerging from the recession at that particular time, I think I can safely say to you that interest rates will be much lower than they are now.

Senator STENNIS. Where do you think that growth will come principally?

Secretary REGAN. I think it will be consumer debt. If you know what has been happening to consumer debt over the last 3 to 4 months, consumer debt has been declining. The consumer has been paying off rather than incurring new debt. At the same time we have had one tax cut, but nonetheless—January 1 of this year we had a second tax cut for those who have two wage earners in the family. There will be another tax cut in July, 10 percent tax cut. And that, by the way, will bring $30 to $35 billion into the economy over the next 12 months. At the same time the social security recipients will receive $11 to $12 billion in additional payments starting July 1, 1982, over the next 12 months as a result of indexing benefits.

Accordingly, with the sum of money such as that—an additional $45 to $50 billion being pushed into this economy from July 1, 1982 to July 1, 1983—I think you will see that that will also fuel recovery.

Senator STENNIS. Thank you.

Chairman HATFIELD. Senator Abdnor.

Senator ABDNOR. I will pass.

Chairman HATFIELD. Senator Eagleton.

### CURRENT ADMINISTRATION BLAMELESS FOR HIGH INTEREST RATES

Senator EAGLETON. Mr. Secretary, in the testimony which you read today as opposed to the thicker document that you filed with the committee, on page 3 you say as follows: "Continued policy failures over a 10- to 15-year period has finally led to the incredibly high interest rates and economic disruptions we face today."

Do you include within that 10- to 15-year period the period of time from January 20, 1981 to February 25, 1982?

Secretary REGAN. No.

Senator EAGLETON. Therefore, if you exclude that period of time, you are blaming our interest rate dilemma totally and exclusively on the past, prior to you folks coming to office?

Secretary REGAN. What I was setting up in my talk, taking it from page 1 on through to page 3, was giving a history of what got us to where we were when we took over in January 1981 and the problems that we faced. Then I went on to try to describe what we did about it.

Senator EAGLETON. The point I am trying to make is, assuming past misbegotten economic policies and which is a bad assumption from your point of view, but I don't quarrel with that. I don't think the administration can disabuse itself of even a scintilla of blame insofar as today's dilemma; that is, dump as much as you want on Jimmy Carter, Lyndon Johnson, or Franklin Roosevelt, but you cannot absolve yourself in some kind of immaculate, pristine way that you folks have had nothing to do with this problem.

You have been in 14 months, don't you have a little to do with today's dilemma?

Secretary REGAN. It depends on which problem you are talking about.

Senator EAGLETON. High interest rates, the problem Senator Hatfield addresses, Senator McClure, and these others addressed.

Secretary REGAN. If you will read, at least it is carried in the New York Times, I am not sure if it is in the Washington Post, a speech delivered last night at the Waldorf before the national conference by James Tobin, a nobel laureate from Yale University, certainly not a supply sider, a liberal, a Keynesian in orientation, he blames the recession on monetary policies, saying Reaganomics had nothing to do with it.

Senator EAGLETON. I am anxious to read that speech. I sometimes agree with Professor Tobin but if that is what he said I will disagree with him.

Let me quote from a Keynesian, not from a Yale professor who is presumably liberal. Let me quote you from a speech on April 22 by one of the most conservative gurus in Wall Street, Henry Kaufman.

Secretary REGAN. Conservative?

Senator EAGLETON. Conservative guru.

Secretary REGAN. I will have to differ from that. Henry Kaufman is far from conservative.

Senator EAGLETON. He told me he even voted for Ronald Reagan. [Laughter.]

Senator EAGLETON. He said on April 22 in his famous speech—by the way 5 days later the stock market peaked at 1,024 and it is down 200 points since then and I know you follow the stock market—Kaufman referred to the Reagan plan in these terms, "Massive tax cuts, large leaps in defense spending, and a slowdown in other Government outlays which he said will not in my opinion be enough. These measures will place an extraordinary strain on monetary policy leading to further distortions in financial markets, much higher interest rates and additional fragility of our financial system."

This is Henry Kaufman speaking in the spring of last year as the Reagan plan was working its way through the Congress. And that is the predictions he made, sadly for the Nation abundantly true.

The point I want to make is that, yes, there have been some sins in the past and it is proper and legitimate in your testimony to refer to them, but do not absolve yourself or do not try to persuade this committee that Reaganomic policy has had nothing to do whatsoever with the economic dilemma in which we currently find ourselves.

Secretary REGAN. By way of rejoinder, I might make a few observations. First of all from the time Mr. Kaufman spoke until December of last year, rates fell about 5 percentage points.

Senator EAGLETON. And the market fell 200 points and long-term rates are pretty much up there.

Secretary REGAN. There the market was correctly predicting a recession and the fact there would be lower corporate profits, which indeed did happen. As far as the Reagan plan is concerned, you must remember in July Congress finally passed our budget and our tax cuts, they were signed in August. The recession actually started in July.

Senator EAGLETON. And some of the depreciation was made retroactive to January.

Secretary REGAN. But it came a little bit late. You couldn't have counted on that.

### ADMINISTRATION POSITION ON REVENUES

Senator EAGLETON. In your testimony you declared certain portions of your budget to be sanctified. You appear to be intransigent in the sense you cannot take one hair off the head of the Defense budget, social security, and evidently interest on the national debt.

Is the administration's position on revenue one of absolute intransigence? By that I will ask this question. Will the administration consider, for instance, doing away with at least a tax loss provision, Charlie Walker's magnificent input into the 1981 tax bill, the one in which Occidental Petroleum and Burlington Northern are making a killing, these two beleaguered companies that are crippled—crippled with profits.

With that kind of tax larceny, will that continue to be sanctified and condoned by this administration? Will you not consider any proposal to get rid of that kind of tax larceny?

Secretary REGAN. As far as leasing is concerned, I will speak to that in a minute. I want to remind you we have come up with some suggestions which I presented to the Senate Finance Committee and the Ways and Means Committee last Monday for some changes in the tax laws that would raise taxes by approximately $20 billion in 1983 and more than that——

Senator EAGLETON. Is the Charlie Walker item one of those proposals?

### ACTIONS TAKEN ON LEASING

Secretary REGAN. What we have done as far as leasing is concerned, is to suggest strengthening the corporate minimum tax which is currently on the books. It now includes accelerated depreciation, capital gains, percentage depletion, and a few other items. We propose to include some parts of the leasing provision rather than to kill leasing entirely.

I will tell you why we don't want to kill it entirely. It does help some ailing industries in the United States. If the Ford Motor Co. or if General Motors or other companies of that nature did not have the right to sell their investment tax credits, they couldn't use them because obviously they just posted the second largest losses collectively in their entire history, second only to 1980.

Now, we propose to help them, to help the steel industry, to help small business, to help new business—remember, if a new business just getting started cannot use investment tax credit, if it has no other income to offset.

Senator EAGLETON. Is anybody in this day and age starting a new business? They are all closing, not opening.

Secretary REGAN. Quite a few businesses start regularly.

Senator EAGLETON. Courageous folks.

Secretary REGAN. What we are trying to do is help those industries so you have to make sure you see the other side of the coin of leasing. I have asked everybody, and I would ask this committee to please hold your fire for a while. There is a study that this Congress has mandated to be made by the Treasury with reports due from corporations on January 31 of this year. We now have that data, and we are giving top priority to try to finish the study so we all will have the facts from which to start our discussions rather than to think of a few glaring examples and legislate on the basis of a few glaring examples.

Chairman HATFIELD. Thank you.

Senator Mattingly.

Senator MATTINGLY. Good to see you here, Mr. Secretary. The battle gets back to the taxpayers versus the other side who think—which I think after 14 months everybody looks where they are going to lay the blame—that we can go back and tax and spend our way to prosperity.

When I went home, I didn't see one person that wanted a tax increase. When we come back here, it gets back to the fundamental topic again, where are we going to raise revenues, and they keep forgetting to look to the other sections that gives the opportunity back to the private sector to create jobs.

### PRIVATE SAVINGS

But putting aside the deficit for one moment, do you have any figures about what is going into saving now as the result of the tax cut, what minimum amount of tax cut we have so far, and any projection what we will be pumping into the saving institutions?

Secretary REGAN. Our calculations, Senator, are to take the normal growth in savings year-over-year, it exceeds $40 billion, and add tax cuts for 1982 for business which are about $10 billion that is entirely savings. In addition, we estimate that individual saving will increase by about 40 percent of the individual tax cut from 1982 to 1984. We have two new things in place now, the IRA/Keogh plans that were increased, plus the "all- savers." As yet it is too early for me to be able to tell you how the IRA's are coming along as far as savings are concerned. On an overall basis, the savings rate in the final quarter of 1981 rose to about 6.1 percent. That compares to 4.6 percent in the first quarter and an average of a little over 5 percent for the last 3 or 4 years.

We think that the savings rate will definitely increase this year to become much higher than 6.1 percent, probably in the 6½ percent range this year.

Senator MATTINGLY. It would be safe to assume, when you cut taxes, obviously people got money to save; when it is increased you are going to say we are going to have less money to save. Is that correct?

Secretary REGAN. That is entirely correct.

### ENTITLEMENT PROGRAMS

Senator MATTINGLY. Are you open to the idea that we need to continue to pursue changing the entitlement program? Yesterday we had quite a debate. We had agreement on both sides. I know there has been some approach made by the administration but I think there ought to be a stronger approach made even on fiscal year 1983 budget on the entitlement program to try and encourage some incentive in that area.

Secretary REGAN. I would suggest we would be more than willing to listen to whatever the Congress would try to coalesce around. What I have attempted, particularly in my own area of responsibility—taxes—is to look at every plan and not jump on any particular one until we see all of the proposals, see whether or not there is a coalition forming around certain types of things.

The administration itself would welcome that and would want to discuss the plans.

### CALIBRATION OF CONSUMER PRICE INDEX

Senator MATTINGLY. You agree that CPI is not calibrated properly?

Secretary REGAN. Yes.

Senator MATTINGLY. Everybody. I have found so far no one in disagreement with that, which means we are wasting money of the taxpayers that comes into the Federal Government by utilizing that CPI.

Secretary REGAN. I agree. I find one thing curious, Senator, that you require the administration to give you a 5-year projection of what inflation will be, but then when you set COLA's you set them retrospectively. In other words, the COLA for this year is based upon last year's rate of inflation. That is curious to me. Why do you want us to project what inflation is to be if all you are going to use is last year's inflation rate? I think there may be an area here that bears examination.

Senator MATTINGLY. I hope to help you in that respect soon by holding some hearings. I think that Allen Greenspan and a few others will probably be able to find a better way to accomplish computing the CPI.

Let me ask you another question about the M-1 growth. I have heard both sides of this. I heard Volcker talking and everybody else.

### INCONSISTENT GROWTH PATTERNS

Hasn't there been an inconsistent growth patten for the last 12 months?

Secretary REGAN. Year-over-year, they accomplished what they wanted. As a matter of fact, they came in lower than they wanted.

Senator MATTINGLY. I won't ask whether Chairman Volcker is doing a good job or a great job.

Is the Federal Reserve really a controllable type agency?

Secretary REGAN. The Fed says that the instruments that they are using, the only instruments they claim are available, are too blunt to be as precise as we would like or as many others would like. On the other hand, the Monetarist School says that they could use other instruments. These have been suggested, certain changes in accounting, for example, and various other types of suggestions of that nature. I think what is needed here is an examination by the Fed of its instruments to see whether or not they can improve their performance.

Senator MATTINGLY. All the tax money that comes into the Federal Government, where does that come from?

Secretary REGAN. From the taxpayers, the individuals. From individuals.

Chairman HATFIELD. Thank you, Senator Mattingly.

Senator Chiles.

Senator CHILES. Mr. Chairman, I had an opportunity to question the Secretary yesterday in the Budget Committee so I will waive.

Chairman HATFIELD. Senator Specter.

Senator SPECTER. Thank you very much, Mr. Chairman.

### UNEMPLOYMENT

Mr. Regan, we have just returned from a recess. We talked to a great many people in our home States and among those I talked to were people in long unemployment lines in unemployment offices in Pittsburgh and Philadelphia. A lot of other people complained about this same problem.

In your testimony you talked about needing time to solve the problem and also say that the policies will work if they are left alone. How much time do you think it is going to take?

Secretary REGAN. Take for what, Senator?

Senator SPECTER. For the policies to work, namely, for unemployment to be significantly reduced in this country.

Secretary REGAN. What we have projected is that the recovery starts in the second quarter of 1982, the second calendar quarter of 1982 and recovers quite appreciably in the fall of 1982 and continues in 1983.

As far as unemployment is concerned, unfortunately that lags the general recovery, it is not a leader in the recovery. That is understandable because employers don't normally hire until such time as they are certain that the recovery is underway. Until then, they generally rely upon overtime.

So, while I think that unemployment will come down, it won't come down nearly as much in 1982 as we will want, but I think by 1983 it will be way down.

Senator SPECTER. When you say not as much as you want or way down——

Secretary REGAN. From the 9 percent area we are projecting unemployment into the low 8's, 8 to 8½ percent by the end of 1982.

### PROJECTED DEFICIT FOR 1982

Senator SPECTER. When you talk about projections and you talk about a $91 billion budget, it raises a lot of question about the accuracy of your assumptions. What do you now think that the deficit will be for fiscal year 1982?

Secretary REGAN. Somewhere probably in the neighborhood of $95 to $100 billion.

Senator SPECTER. A year ago this time the figure was projected at $42½ billion. What will the deficit be in fiscal year 1983 if the optimistic projections are wrong? For example, if the unemployment rate goes to 10 percent, as some in the administration predict, and if the real growth is, say, 4.4 percent instead of 5.4 percent, where would that leave a projected $91 billion deficit?

Secretary REGAN. A sustained 1 percent change in GNP accounts for about $13 billion, I believe it is, of revenue. So we can lose about $13 billion of revenue, if it would go down 1 full percentage point.

We are projecting real GNP growth of 5.2 percent in 1983 and then 5 percent for 1983. If it were down in the 4 percent area, your deficits would be accordingly higher unless there were additional cuts in the budget by the Congress.

Senator SPECTER. So if the unemployment rate goes to 10 percent, the administration will have been warned about that?

Secretary REGAN. I think we are warned about that happening this winter. I think if we get recovery starting in the spring that we need not worry whether there will be a 10-percent rate of unemployment. However, the estimate is about $25 billion additional deficit for each 1 percent rise in unemployment, due to increased outlays as well as decrease in tax collection.

### EFFECT OF HIGH DEFICIT ON NATION IN 1982

Senator SPECTER. Mr. Regan, when you talk about more cuts in the budget, the budget cuts were agreed to last year by the Congress as part of a real effort to reduce the deficit. When Senator Proxmire quoted your testimony of last year to the effect that you cannot have a $60 or $70 billion deficit without ruining the country, what has changed in 1982 as opposed to 1981? Can we have a $60 or $70 or $91 billion deficit without ruining the country?

Secretary REGAN. You have to look at what caused the deficit. A substantial part of the deficit was caused by the recession. We will lose $31 billion as the result of this recession for the period of fiscal 1982. It depends upon how much of that you can make up. Are we starting from a lower base than we had originally forecast? No one had forecast that we would have a recession in 1981 or early 1982 of this magnitude. Therefore, our projections, CBO projections, DRI, any major forecast you choose, did not factor in the recession. When I was talking about it last year, I was talking about it with no knowledge we would have such a recession. As I said in answer to a previous question, we have our choice and so does the Congress, how are you going to get these deficits down? If you chose to get them down by increasing taxes, you can well abort any recovery we have because what is the incentive to a business, incentive to an individual to work harder if you are going to tax more away from them? We chose to borrow the money rather than to tax.

### MONETARY POLICY

Senator SPECTER. Mr. Regan, you have been critical, at least to some extent, of the Fed's monetary policy. You talked about 1 percent growth in monetary policy for a substantial part of 1981 and you attribute the recession to the monetary policy.

Would it make better sense philosophically if the monetary policy were not with Fed but were with the administration? Are we having two quarterbacks operating on a very troublesome economy with the administration saying that the problems are due to the Fed and the Fed saying that they are independent? Would it make any sense for us to change the law and give that responsibility to the administration?

Secretary REGAN. This requires more time for an answer, Senator, than I might have. It is a very lengthy discussion. We are the only Nation in the world where the finance minister does not control the central bank. Germany, Japan, England, anywhere else, the central bank does report to the finance minister in that way. We have chosen a different path here. I don't think you have two quarterbacks. I think you have a coach and a quarterback that has an election for options.

Chairman HATFIELD. Thank you.

Senator Sasser.

Senator SASSER. Mr. Secretary, you just made what I thought was, if I understood you correctly, a startling statement, to me anyway.

You, in response to one of Senator Specter's questions, you said and I wrote this down, "That we choose to borrow rather than to tax," is that correct?

Secretary REGAN. That is an accurate statement.

Senator SASSER. Well, Mr. Secretary, I was astonished, frankly, to hear you say that because I had been reading your testimony from your last appearance before this committee, as I recall it, in January 1981, at that time in response to a question from Senator Stevens, you said, "I don't think that we can sustain $60 and $70 billion deficits year after year without ruining this country."

Now, it appears to me that this administration is embarked on a program that is directly contrary to your statement you gave this committee back in January 1981.

You are telling us today that the administration chooses to borrow rather than to tax, that the administration intends to live on credit rather than to pay its way.

That is a shocking revelation to me, particularly coming from the Secretary of the Treasury of a Republican administration.

During my entire lifetime all I have heard from the economic spokesmen from your party is that we must live within our means, that we need to balance the budget and you were reiterating that before this committee in January 1981.

Now, we have before us budget deficits predicted by this administration for fiscal year 1983 of $91.5 billion, 1984 $82 billion in 1985 $71 billion, and these are budget deficits which are based on what many of us think are very, very dubious assumptions.

### UNEMPLOYMENT INCREASES

And I think Senator Specter put his finger on it a moment ago when he said: "What happens when the unemployment rate goes up?"

In my State, for example, which you will visit tomorrow, a Sunbelt State, we have an unemployment rate there of 10.5 percent above the national average; Those are the ones that we can still count.

Well, what is the reason for this problem we are having?

My horseback opinion is, I think you will probably agree with this, that the real problem at this juncture is interest rates, high interest rates.

Now, if you believe the crowding out theory, I think I heard you enunciate your belief in this theory before, that if the Federal Government is elbowing its way up to that loan window, it elbows everybody else out of the way where everybody has to bid the money up.

### GOVERNMENT BORROWING

My question to you; isn't this policy of borrowing to finance the Government rather than paying our way, as we have heard for all these decades since 1932, isn't this the real culprit in these high interest rates?

It is killing any hope of an economic recovery.

Secretary REGAN. No; there are several answers to your statement, Senator.

First of all, you have to recall why we have the high deficits that we are now projecting. These have been induced by a recession, a major recession.

As I said in answer to Senator Specter, we have lost over $30 billion as a result of this recession in receipts to the Treasury from lower income, both corporate and individual.

Now, what would you do to cover that? Would you tax more? If you tax more, what do you do? You certainly destroy incentives, you don't give yourself a chance to work out of the recession if you are going to tax the people of Tennessee or the people of the rest of the United States in order to make this up.

So we chose not to do that.

### BORROWING RISKS

Now, can we afford this borrowing? Yes; there is a certain element of risk there. I submitted a chart, which is attached to my prepared statement, that shows gross domestic savings. There you will see, in green, the total amount of savings that we are projecting, the red is the borrowing by the Federal Government and as you can see, we are not crowding out the rest of the business sector by our borrowings at this time.

I am not saying the deficits are good, no. We don't believe in deficits. I wish we would get them lower, we welcome other cuts in the budget. We don't think the way to reduce the deficit is to increase taxes at this point.

### BUSINESS AND CORPORATE INCENTIVES

Senator SASSER. Mr. Secretary, we have had long debates and discussions last year in this committee and the Budget Committee and on the floor of the U.S. Senate where we were debating the tax cuts about the necessity for incentives and give the business community in this country a tax incentive and they will take hold and come forward and blast us back to prosperity very quickly.

We gave them those tax incentives. Senator Eagleton referred to some of them as tax larceny and I am inclined to agree with that characterization of some of them, particularly the leasing provisions.

But we gave them the tax incentives and in a further effort to restore business confidence there were massive budget cuts, massive tax cuts, what have we gotten in return?

More bankruptcies in small business than any year since the Great Depression year of 1933, more unemployment than any year since the World War II, continued high interest rates and we see business, rather than taking these incentives and expanding their business, they are pouring their money into the money market funds.

I'm beginning to be dubious about this policy of give them the incentives and then they will come forward.

What is your response to that?

Secretary REGAN. Senator, you must remember that while the business cuts which are 25 percent of the total tax cut have gone into effect, only the first 5 percent tax rate cut has gone into effect for individuals so far; 10 percent, the second portion of the tax cut comes into effect on July 1, 1982.

I will stand by my statement. I think that when this tax cut is finally in place you will see what is going on, but certainly a 1¼ percent drop in taxes for an individual is hardly enough to stimulate the economy.

I think you have to admit that we have not had a chance yet to see what the stimulation will be.

As I said in answer to a previous question, $30 to $35 billion is the amount of that 10 percent cut that is coming on July 1.

I think that is quite a bit of money to be afforded the economy. You would see the results.

One quick answer on the business thing. You know as well as I do that when you are planning a new expansion in business you run the figures through the computer. If you are building a new building or purchasing something, you are going to have to use 17 or 18 percent money, two or three points over prime.

There is no way you can make a profit on that type of thing regardless of the tax break you are given.

So the average businessman has to hold off until his computer runs show it to be profitable, and that will be somewhere around a 14-percent interest rate.

If he can get 14 percent money he can start to make a return.

Chairman HATFIELD. Thank you.

Senator Abdnor?

Senator ABDNOR. Thank you, Mr. Chairman.

### DROP IN INTEREST RATES

Like many other members of the Congress, I was home during the entire recess and the big topic is interest, high interest. Some are tolerant and some aren't.

If this Congress was to take further steps and make deeper cuts in the budget, I guess specifically they have to delve into things like entitlement. We would go further than you have.

Do you think that would show good faith with the money market and interest rates would drop more rapidly than you are predicting interest rates to drop.

Secretary REGAN. I would have to agree with that. I would think any further cuts in this budget to get the deficit below $91 billion would be very stimulative to the money markets.

### OFF-BUDGET ITEMS

Senator ABDNOR. It is easy to talk here. But we have talked often about what percent of the savings the Government takes. I don't think you show in your projections the off-budget items. The direct loans, the guaranteed loans, would that also make quite a difference?

Secretary REGAN. Oh, yes, very definitely. We are projecting some cutback in the off-budget items from what they were, to the neighborhood of about $10 billion in the new budget that we have submitted. Anything that can be done to reduce additional Government borrowings would be helpful.

Senator ABDNOR. I am sure they follow our program as closely as we do. I don't think you have to look too long in the budget to know if you are going to make a decision on all cuts. You can cut very deeply in many areas now that they have to come, the entitlement programs that make up a large portion of the budget.

So if this Congress really had the courage to do something about it; make some corrective proposals and adopt them. Do you think that that would be the one force that would really help bring the rates down?

Secretary REGAN. Yes; I am talking now in an overall sense. I am not saying exactly where these cuts would be made but I am talking in overall sense, yes.

### ENTITLEMENTS

Senator ABDNOR. We don't talk too much about entitlements but maybe we have to. Whatever we do its going to take Congress to make a change in the law, and doing that is being pretty bold in an election year.

But nevertheless, it is something. You have done a considerable amount of paring in the areas where we can do it without corrective measures. From here on, in it is up to us if we want to make further reductions. You cannot ignore it, and maybe the one area if we would take that, would put some confidence back.

You can talk all you want to about stimulants, we don't have a lot of big corporations in South Dakota but we have a lot of small businessmen and farmers. But I believe if those interest rates would take a considerable drop, you would see them so excited, so full of confidence that they would add quite a contribution to the economy.

So these are things we have got to weigh if we really want to see the rates come down.

Secretary REGAN. That is one of the reasons why we are so anxious to get the rates down. You will recall those statistics, Senator, from a study of the period of 1966 to 1976 that indicated that over 70 percent of new jobs came from firms that employed less than 100 people.

So we are very anxious to see small business revived in this country because that is where you get a real impact on the unemployment figure.

Senator ABDNOR. If I had to make a decision in my area, what is more important, the tax cuts or lower interest rates, it wouldn't take long to come to a conclusion.

If we want interest rates to come down, we have to qet together.

Secretary REGAN. The President said in that regard, that he would like to see any comprehensive package that the Congress might have. And he has constantly stressed that, not just a piece here and a piece there, but a comprehensive package, he would be more than willing to discuss it.

Chairman HATFIELD. Thank you, Senator.

Senator DeConcini?

### FISCAL EXCESSES IN CONGRESS

Senator DECONCINI. Mr. Secretary, let me address a couple of areas that trouble me. One is in your statement you make reference to past sins, if you want to call it that, and I have to agree with you.

I think there have been excesses in both Democrats and Republicans' administration in the Congress. I get the feeling from your reference to Mr. Tobin's article today in the Times that you subscribe that the administration is not at fault for this present situation; is that correct?

Secretary REGAN. Well, if you are referring to the current recession, I don't think that this administration brought this recession on.

Senator DECONCINI. What about the high interest rates?

Secretary REGAN. The high interest rates, I think that in part this administration has brought that on by the deficits, but I don't know what portion or how you weigh one versus the other.

Senator DECONCINI. Do you think the high interest rates are more related to the monetary policy or the deficit?

Secretary REGAN. Personally, I think they are more related to monetary events than deficits.

Senator DECONCINI. That is what your statement says but you don't rule out the deficit playing a major or some role?

Secretary REGAN. Playing a role in it.

Senator DECONCINI. Your statement of programs for economic recovery in February 1981 set out a lot of things and I realize those things are difficult to have anybody speak on, but it really troubles me that the administration takes credit, and I am glad to give it to you, for lower inflation, however can take credit and get inflation down deserves a pat on the back and an applause from everyone.

The struggle here is that inflation has fallen and interest rates, in my judgment, have not come down substantially or proportionately.

In your economic plan, it says "moreover if monetary growth rates are restrained, then inflationary expectations will decline. And since interest rates movement are largely a mirror of price expectations reductions in one will produce reductions in the other."

I didn't get a clear understanding other than we are in a recession, why that hasn't worked.

Was that a miscalculation on the part of the administration in making that statement and those assumptions?

Secretary REGAN. This is what I was tryinq to explain in answer to an earlier question regarding the uncertainty premium that is being charged today.

We have a 5- to 6-percent gap between what we think interest rates actually should be and where they are. That is in both the short term area in the prime rate and in the long term, 20- and 30-year bond.

Senator DECONCINI. So that was a miscalculation.

Secretary REGAN. It is not a miscalculation. It is simply something that is not understood by anybody. Milton Friedman, for example offered eight reasons as to why this premium existed and then destroyed each of the eight and came to the conclusion he didn't understand it either.

Senator DECONCINI. But you and the administration calculated that that would not occur and in fact it did; is that right?

Secretary REGAN. We are saying that it is here now but by the time our program is in effect and people have had time to see that inflation is down, it will disappear.

## ALTERING TAX CUTS

Senator DECONCINI. Mr. Secretary, the President in his statement, and yourself in your statement, rule out, I guess, any substantial consideration as to altering the tax cut that was passed.

I happen to be one of those Democrats that joined with the administration. I wanted to see this economy turned around, some of the policies of past administrations had not worked, I welcomed the opportunity. I couldn't tell you with any great satisfaction that I see it working. I am not as optimistic as you seem to be, but I do ask you, what would be the increase revenue to the Treasury if the 1984 10 percent tax cut was deferred or put off?

Secretary REGAN. It is approximately $30 to $35 billion perhaps slighly more out in 1983.

I would say $35 billion is the ballpark figure.

Senator DECONCINI. In the process of attempting to weigh the need to borrow money versus taxing, I presume any reduction of the 1984 tax cut, the Kemp-Roth part, the across-the-board, is considered taxes in your decisionmaking process; is that correct?

Secretary REGAN. Yes.

### TAX CUT DETERRENCE DEPENDENT ON REDUCTION IN DEFICIT

Senator DECONCINI. Along that line, was there any consideration or would there be any consideration to a partial deferrence of that tax cut and a condition of that deferrence being based on a substantial reductions of the deficit so that if your economic program works in part, if the cuts are enacted and if the deficit is less than what is projected now, the full tax cut would be in place if not perhaps only half a loaf would be given to the American public.

Has that been seriously considered, making one conditioned upon the other?

Secretary REGAN. We decided against that, Senator, for this reason. The tax cut for the—I am talking now about the cut for individuals, that was enacted and went into effect on October 1, 1981—the second part of the cut effective July 1, 1982, merely brings the average taxpayer even with the board, because his taxes are increasing as a result of inflation. The tax reduction actually goes into effect with the third and final part of the tax cut, the 10 percent that is due July 1, 1983.

So, if you take that final cut away, what in effect you have done is to give no tax cut at all for—in spite of the fact that you think you have given a 25-percent tax cut, you are giving no tax cut at all unless you do have that final push.

Chairman HATFIELD. Senator, your time is up.

Mr. Secretary, I promised I would have you out by 11 o'clock. It is now 11 o'clock.

We appreciate very much, with your hectic schedule, your willingness to come here.

### REDUCING EXPENDITURES

Let me make one final observation as far as the Appropriations Committee is concerned and our desire to help in balancing the budget, by reducing expenditures. The observation is simply that in the fiscal year 1983 budget, the interest on the national debt is $112.5 billion.

The total of all nondefense discretionary programs over which this committee has jurisdiction, and in which we are expected to make some rather significant reductions, is $98.7 billion. It is an interesting comparison.

We anticipate spending $112.5 billion for servicing the national debt, and yet all of our nondefense discretionary programs are under that figure at $98.7 billion.

Secretary REGAN. I am glad my time is up.

Chairman HATFIELD. Thank you very much.

SUBMITTED QUESTIONS

Senator STENNIS. Mr. Chairman, I ask permission to file additional brief questions.

Chairman HATFIELD. All members will have the opportunity of filing additional questions for the Secretary. Those questions, together with the responses will appear at this point in the record.

[The following questions were not asked at the hearing but were submitted to the Department for response subsequent to the hearing:]

## QUESTIONS SUBMITTED BY SENATOR HATFIELD

QUESTION:

Economist Alan Greenspan puts the odds at no significant recovery from the present recession at 1 in 3. What is your judgment on the prospects for no recovery, or a very modest one?

ANSWER:

Mr. Greenspan's prediction, as quoted by you, certainly is a guess based on his gut feeling, rather than a precise statement based on a scientific study of the relevant probability distribution. The precise odds that there will be no significant recovery are anybody's guess, but very small.

Given the monetary policy we expect from the Fed and given the fiscal policy incorporated in the President's budget, our expectation is that the economy will recover nicely in the latter half of this year. A great many of the most influential forecasters inside and outside government, including the CBO, predict that the economy will begin to pull out of the recession by mid year.

Certainly the Administration's forecast is not risk-free, but by historical standards it is not overly optimistic either. Real GNP is expected to grow an average of 4.8 percent per year over the eight-quarter period beginning April 1982, which is a little slower than is typical for the early stages of postwar recoveries. For example, excluding the Korean War and the aborted 1980-81 recoveries, postwar recovery growth averages about 5.4 percent per year for the first eight quarters.

QUESTION:

The Administration has placed strong emphasis on inherited economic programs and problems. Do you regard the 1981-1982 recession as another such heritage? When do you expect to be rid of this kind of burden?

ANSWER:

According to the National Bureau of Economic Research, the recession began in July 1981, before the President's economic program even began to go into effect. Obviously, the recession reflected responses to previous policies rather than to the Reagan Administration's program.

With only brief exceptions, interest rates have been high--mostly in the teens--since the fall of 1979. High and rising interest, inflation, and tax rates cut short the recovery from the 1980 recession and produced, back-to-back, the current recession.

The burden of past policies will end as soon as President Reagan's program is phased in. The tax cut is in place, on schedule, and should not be derailed. The growth of federal spending has been cut, but additional trimming remains to be done. The announced monetary policy of the Fed is acceptable, but requires some improvement in the implementation of a steady reduction in monetary growth.

QUESTION:

What differences in effect are there between removing money from the economy by borrowing, and by taxing?

ANSWER:

Borrowing takes a portion of current national savings out of current national income (which equals current net output) to enable the government to purchase a portion of current output. Taxing also enables the government to purchase a portion of current output. Like borrowing, it reduces savings by a substantial amount. However, there is a difference. In recent years, tax increases have generally taken the form of allowing inflation to push taxpayers into higher brackets, or allowing inflation to erode the value of depreciation allowances. The former reduces the value of incremental present or future wages and interest income; the latter reduces the rate of return on plant and equipment. The effect is to reduce the supply of labor, savings, plant and equipment, cutting down on future output. Thus, taxation often produces disincentives which adversely affect future output, as well as directing a portion of current output to the government. Federal borrowing creates debt that must be serviced, and this implies the future payment of taxes, but it need not require an increase in marginal tax rates, as long as economic growth produces an enlarged tax base.

QUESTION:

Chrysler Chairman Lee Iacocca has argued that while there is plenty of money for the U.S. Treasury to borrow, and plenty for DuPont to buy Conoco and Sears to buy Dean Whitter, there is no money available for the purchase of autos and housing. As a result, these industries, which create jobs by additional sales, are in desperate condition. So he believes in credit allocation, and argues that the Federal Reserve should nudge the banking community to supply credit at more favorable rates to job-creating industries such as housing and autos. What is your response to this view?

ANSWER:

The Reagan Administration would oppose any proposal that the Federal Reserve engage in a program of credit allocation.

Borrowing to finance the acquisition of shares does not in any way reduce the amount of funds available for investment--the sellers of the shares receive payment, and the funds are returned to the banking system or used to purchase stocks, bonds or other assets directly. Thus, the premise of Mr. Iacocca's question is invalid.

QUESTION:

Are we on the road to ridding our economy of the abnormal inflation we have suffered in the past decade, or can the recent drop in inflation be attributed entirely to the economic slowdown and external factors such as the glut in the oil market?

To what extent have Administration policies brought about the reduction?

ANSWER:

The reduction in the rate of inflation is due to the reduced rate of growth of the money supply--not because of the oil glut or the economic slowdown. To maintain this reduced rate of inflation along with other features of a healthy economy we must increase the supply of goods by raising productivity and the rate of real economic growth. The Reagan Administration's tax cut is designed for this purpose; it increases after-tax returns to productive factors, thus encouraging more employment of labor and capital which raise the growth of output.

QUESTION:

The projection of the FY 1982 budget that declining inflation would be compatible with fast growth in real output went awry. The present budget makes no such projection, but still there is an expectation that recovery in 1982 and beyond will be accompanied by a steady downward trend in inflation, to below 5% eventually. On what basis do you expect this to happen?

ANSWER:

Inflation abatement and a rise in real growth are compatible and indeed closely linked. Maintaining a slow, steady decrease in the year-to-year growth of the money supply will yield reductions in actual and expected rates of inflation, thus providing more certainty for lenders and borrowers. As a result, interest rates will come down and real investment will increase, bringing improved productivity gains and rising growth in real GNP. At the same time, fiscal policy based on cuts in marginal tax rates, more rapid capital cost recovery rules, and reduced growth in federal spending also contributes to heightened incentives for real growth. Thus, by synchronizing monetary policy which reduces inflation with fiscal policy which encourages real growth, the growth rates of the money stock and of output of goods and services are brought into step, and inflation is avoided.

QUESTION:

Herbert Stein, in an article in Fortune Magazine, made this statement: "Many Administration statements still reflect the notion that taxes are not only an evil but an unnecessary evil. This is a vestigial remnant of the theory, prominent during the campaign, that a reduction of tax rates would increase tax revenues, in addition to having a number of other good effects. Although hardly anyone believes this anymore, the taxophobia rationalized by this idea remains an element of Administration thinking." What is your reaction to this statement?

ANSWER:

The goal of the economic policy of the Reagan Administration is to produce a larger GNP, higher employment, and higher real wages. Our policy is based, in part, on the fact that excessive rates of taxation reduce economic growth. Our tax cuts will increase real growth and, in the process, some revenue recovery will occur until spending restraint and real economic growth bring the budget into balance.

It is always possible to try to maximize federal revenues by loading the economy down with taxes. This will result in lower growth rates and lower standards of living. The only way to balance the budget while increasing employment and living standards is to encourage economic growth and restrain spending.

QUESTION:

Last year, at the oversight hearings on the FY 82 budget before this Committee, you offered the view that "the key element in the President's program is reduction in tax rates for individuals and an improved tax climate for capital formation." We have the first of these, but do we have the second? Or even the near prospect of the second?

ANSWER:

Yes, the tax on income from capital has been reduced by several provisions of ERTA. The individual income tax rate reductions reduce the marginal tax rates in all brackets on income from all sources including capital assets. The reduction in the maximum individual income tax rate lowers the rates on "unearned" income and capital gains that previously exceeded 50%. The capital cost recovery provisions accelerate the rate at which tax deductions can be taken for depreciation, and thereby reduce the double taxation of capital that results from the interaction of inflation and depreciation based on historical cost of assets. Corporation income tax rate reductions are beneficial to stockholders. In addition, ERTA provides saving incentives including the partial exclusion of interest and dividend income from tax, tax exempt saving certificates, IRAs and Keough plans.

QUESTION:

The Administration has stressed the incentive effects of tax cuts, as generating savings, higher investments, improvements in productivity and reduction in inflation. Are not these strictly long-run effects? What if a slack economy and ongoing (if lower) inflation make investment a less appealing option?

ANSWER:

Investment will, to use your terminology, become a more appealing option when the expected after-tax rate of return improves. This, in turn, is a function of actual and expected rates of inflation and tax rates. We expect monetary policy to continue to provide steady, but reduced monetary growth and, thus, continue to bring down actual and expected inflation. As noted above, the tax on return to capital has been reduced by ERTA. Prospective investors respond more or less quickly depending on the nature of their investment opportunities--some responses occur immediately and others require much more lead time. Other factors may intervene to delay the investment responses to reduced inflation and tax rates. But responses occur along a continuum rather than being "strictly long run." And, in the aggregate, the process is self generating in that those responses that occur sooner improve overall economic conditions which then hasten and heighten the responses that require a longer gestation period.

QUESTION:

The Administration has stated that personal savings will increase substantially because of the tax cuts, and these savings will permit the government to borrow record amounts, while also leaving capital available for business expansion. Just how much additional savings do you predict we will see because of the tax cuts? One estimate of last year's figures is business saved $372 billion, and individuals saved $100 billion. The federal government took 12% of this total. How will these figures change this year?

ANSWER:

The savings figures you cite refer to gross saving for calendar 1981. On this basis the Federal government absorbed 13% of the total. In calendar 1982, we expect gross private saving to be about $542 billion, of which about $391 billion is business saving, and $151 billion is personal. Because of the recession, business saving shows an especially small year-over-year increase, and the federal government absorbs about 19% of the total, which is relatively large, but still manageable. For 1983, we project gross private saving of about $650 billion, with about 16% absorbed by the federal government. For 1984, we project about $740 billion in saving, with less than 13% absorbed by the government.

QUESTION:

We have been getting conflicting signals on the Administration's attitude toward the current monetary policy of the Federal Reserve. In January, you and the President were critical of the recent growth in the money supply. More recently, the President praised the Fed. What is the Administration's attitude toward the Fed's policy? What do you believe that policy should be?

ANSWER:

The Administration wants the money supply to grow at a moderate and steady pace in the upper third of the Fed's target range, i.e., about 5% for this year. Year-over-year we would like to see slow reductions in the growth of the money supply. This is the announced goal of the Fed and we support it. From time to time we have had some differences about the implementation of policy, especially when money supply growth rates shoot up over a period of several months.

QUESTION:

One Wall Street economist has stated that while the whole thrust of fiscal policy is expansive, monetary policy is anti-growth, and that this contradiction has resulted in the punishing level of interest rates and the present recession. Do you believe this is an accurate assessment?

ANSWER:

The quoted statement is not an accurate assessment, rather it appears to be a package of obsolete cliches. The Reagan Administration has cut taxes in a way that restructures the marginal tax rates. The cuts will barely be large enough in dollar amounts to nullify bracket creep and the rise in social security taxes. However, this restructuring of the tax code increases after-tax returns to productive labor and capital and provides incentives to increase the amount of work and saving and investment undertaken and thus improve real economic growth. We also have cut the growth in federal spending to release resources for private use. The deficit has been enlarged mainly because of a recession that began prior to Congressional enactment of the President's tax and spending proposals. No reputable economist would conclude that fiscal policy is "expansionary" in the Keynesian sense simply because the federal budget is in deficit during a recession. Rather than being "expansionary" in some sense, our fiscal policy is pro-growth because it restructures and restores incentives. We have asked the Fed for anti-inflationary monetary policy of a gradual steady reduction in the rate of growth of the money supply. The Fed has announced such a policy and, for the most part, although with some exceptions, has implemented it. That policy is anti-inflationary, pro-growth, rather than anti-growth. Unless actual and expected inflation are reduced, interest rates will remain high, as they have been for about two years, and retard the growth of investment. The contradiction is in the quoted statement, not in our economic policies.

QUESTION:

How do you achieve consistency between budgetary policy and monetary policy? Are the Administration's economic assumptions the same as those of the Fed? If there are differences, how do you take account of the possible differences in policy intent?

ANSWER:

As noted in answers to previous questions, there are no differences in either the policy intent or the economic assumptions of the Administration and the Fed. Both are anti-inflation, pro-growth. There has been some delay in Congressional enactment of the President's tax and spending proposals. And, there has been a period of learning at the Fed subsequent to the 1979 change in the focus of monetary policy. But our expectation is that the implementation of fiscal and monetary policy will become more and more congruent as we move along through the year.

QUESTION:

Would you expect that the recent phenomena of labor surrendering previously won wage concessions will spread to other depressed industries? Do you think this is healthy for the American economy? Does this indicate the possibility of a significantly reduced wage-price spiral in the years ahead?

ANSWER:

High and rising wage rates and fringe benefits, driven in part by high and rising marginal tax rates, has pushed labor costs so high that many products made with U.S. labor are priced too high for world markets. The tax cuts will help by removing some of the pressure that drives wage bargains upward, and by helping to boost investment which will improve labor productivity and thus further reduce labor costs. In addition, the renegotiation of labor contracts reflects a restructuring in response to reduced inflation. As our economic program takes hold we can expect increases in productivity to provide increases in real wages while, at the same time, lower inflation reduces that component of the rise in nominal wages.

QUESTION:

The rate of business failures has risen sharply over the past few years of high interest rates. Failures per 10,000 businesses were 27.8 in 1979, 42.1 in 1980, and a seasonally adjusted 60.8 in June 1981, the last month for which the data are available. Do you feel that this situation is approaching a crisis? What effect will the Administration's plan have on the rate of business failures?

ANSWER:

The observed increase in business failures reflects both structural economic difficulties and cyclical problems. When the Reagan Administration took office, it certainly felt that existing U.S. economic policy which encouraged high and rising tax rates, burgeoning growth in federal outlays, soaring inflation, and exploding interest rates was damaging the structure of the U.S. economy and that the structural damage was approaching a crisis. That is why the Administration undertook a policy to reverse the existing policy. As more and more of the Administration's program is implemented, and as the economy responds to the anti-inflation pro-growth incentives, the structural strength of the economy will improve and this improvement will tend to result in a reduction in business failures. In addition but related to the structural difficulties, the recession in 1980 brought with it a cyclical increase in business failures. Similarly, the recession that began in July of 1981, prior to the enactment of the President's tax plan, will bring a similar increase in business failures. But, as the economy begins to recover and move onto its stronger long run growth path, the rate of business failures will decline.

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## QUESTIONS SUBMITTED BY SENATOR SCHMITT

QUESTION:

A survey of small businesses indicates, despite recent layoffs, many firms plan to increase hiring during the First Quarter of 1982.

Since the vast majority of jobs are created by small businesses, wouldn't this seem to indicate the unemployment rate may soon begin to decline?

When do you predict an end to the current recession?

ANSWER:

It is always good news to hear that a survey shows that many firms plan to increase hiring during the first quarter of 1982. However, it is a documented fact that a decline in the unemployment lags behind the onset of the recovery. We expect the recession to end in the second quarter of this year and the recovery to gather strength during the second half of the year.

Federal Credit Budget

The federal credit budget for fiscal 1983 is $147 billion--roughly a 2.5 percent increase over fiscal 1982. When added to the projected $91 billion deficit in the cash budget, federal borrowing in fiscal 1983 appears to exceed $200 billion.

--Is government borrowing swamping the credit markets?

The figures you cite are gross figures before repayments. The 1983 federal credit budget total of $147.3 billion is composed of new obligations to make direct loans of $49.0 billion and new commitments to make guaranteed loans of $98.4 billion. Neither of these figures represents the net increase. The net increase in direct loans outstanding in 1983 is estimated to be $14.2 billion, and the net increase in outstanding guaranteed loans is estimated to be $46.6 billion.

In fiscal 1983, federal borrowing from the public is estimated to be $108 billion, and this amount includes the net increase in outstanding direct loans. In 1983, federally-assisted borrowing is estimated to be $96.7 billion, of which $46.6 billion is the net increase in outstanding guaranteed loans, and the remaining $50.1 billion is government-sponsored enterprise borrowing. Thus, total federal and federally-assisted borrowing from the public is estimated to be $204.7 billion in 1983, down from $206.0 billion in 1982. By this measure the reduction in federal and federally-assisted borrowing will ease pressures on credit markets. However, these totals are composed of heterogeneous parts. A significant fraction of these direct loans provide financing for private borrowers, and virtually all of the loan guarantee represents federally subsidized financing from private lenders to private borrowers. Therefore, it is useful to look at the separate components rather than just to add them, refer to the total as "federal borrowing" and suggest that this amount is "swamping" private credit markets.

What efforts are you making to control the federal credit budget?

This Administration has worked closely with the Congress to strengthen the credit budget. Now in its third year, this framework is a major step toward full integration of credit into the budget process. In its credit budget revisions just after taking office, the Administration proposed reduction in direct and guaranteed loan activity for 1982 of $21 billion below the level proposed by the previous Administration. Under the President's credit budget proposals, significant progress is being made to reduce the federal claims on financial resources, far below the level they would attain if the growth trend since 1976 continued unabated. For 1983, the Administration's credit budget proposals bring direct loan obligations down by $7.4 billion between 1981 and 1983 and substantially slow the growth in guaranteed loan commitments compared to previous growth trends. This Administration has testified in support of the Bethune-Mineta Bill.

Over the next five years, do you foresee a decline in the Federal Government's share of total borrowing, in order to alleviate upward pressure on interest rates?

Federal demands on the Nation's financial markets will be substantially alleviated in the years ahead. The 1983 budget marks the beginning of a steady downward path in the total burden of Federal credit demands on the nation's economy. As the actual deficit declines in subsequent years, the Government's share of total borrowing will decline even faster as the economy grows and total private credit demands increase. The decline in relative Federal borrowing needs will in turn reduce pressures on interest rates. However, the major downward influence on nominal interest rates will be the fall in actual and expected rates of inflation, resulting from a steady moderate reduction in the growth of the money supply. In addition, Federal borrowing demands and increased private borrowing will be accomodated more easily because the savings rate will increase in response to the rise in real after-tax rates of return, resulting from the Administration's tax cut.

What do you think of the idea of offsetting any projected increase in the Federal cash budget deficit, over the $91 billion Administration estimate, with further reductions in the Federal credit budget?

While we should be constantly seeking ways to reduce Federal intervention in the economy, whether in the form of Federal spending or Federal credit activities, offsetting any increases in the budget deficit with reductions in the credit budget would require careful consideration of a number of factors. For example, the estimated $108 billion of Federal borrowing from the public in fiscal 1983 includes $14.2 billion of borrowing to finance direct Federal loans. While there is no inherent difference in terms of credit market impacts between Federal borrowings to finance direct loans and federally guaranteed borrowings, the net economic impacts of the two programs could differ markedly depending on the degree of subsidy provided by the program. Clearly, borrowing to finance a grant program would have substantially different impacts from those of borrowing to finance a fully repayable loan.

If the Federal credit budget has to be cut another $20 to $30 billion, where would you suggest the cuts be made?

The 1983 credit budget was developed as a part of a thorough review of Federal credit activities. These credit proposals reduce direct loan obligations and slow the growth of loan guarantee commitments. Further reductions would require another thorough review. However, the Administration is continuing to monitor this area closely. As stated in the budget documents, the Administration is moving to develop a consistent policy on the provision of interest subsidies. Reducing interest subsidies will not only reduce the cost of these programs but will also help to reduce the demand for Federal credit assistance.

In a recent article, Fortune Magazine proposed an alternative method of borrowing funds that could save $28 billion on fiscal 1984 interest expenses. They propose to issue inflation-adjusted Treasury notes that pay a small real interest rate instead of the present high-fixed-rate securities.

--What are your feelings about the feasibility of this proposal?

During inflationary periods the Treasury is often asked to consider the possibility of issuing indexed marketable securities which would tie interest payments and/or principal to some price index. The Treasury Department announced in July 1981, that it had reviewed and rejected the idea of issuing indexed marketable securities at that time. However, although the Treasury Department has no current plans to issue indexed marketable securities, it continues to study proposals to do so.

You have argued that the economy can endure the very large projected deficit because the economy itself has grown, and that the deficit as a percent of GNP is high, but not a record. Does this take into consideration the fact that the overall federal debt has grown so much in recent years, much faster than GNP? Is this a concern?

In 1976, the federal debt was 38.5% of GNP, and the federal debt held by the public was 29.3%. For FY 1983, the comparable estimates are 36.6% and 29.7%. Thus, the basis for the question is an assertion of questionable accuracy. In any case, the level of the debt, in and of itself, is not a problem. However, debt service--the interest payments on the debt--can be a problem. In 1976, net interest was 2.4% of GNP, as compared to an estimated 2.8% in 1983, the increase mainly due to increased interest rates. With rates coming down we project net interest to decline to 2.4% in 1985, and to fall again in 1986 and 1987.

## REQUEST FOR ADDITIONAL ORAL QUESTIONING PERIOD

Chairman HATFIELD. Senator DeConcini.

Senator DECONCINI. I want to reiterate my thanks to the committee for the opportunity to have members listen to administration officials, financial side and tax side, but, I want to ask the chairman in consideration for future hearings, if we might have more than 5 minutes' time to pursue the line of questioning. I realize the limited time but we are dealing with a $700 billion plus budget and $100 billion debt and it would be a help at least to this Senator if there could be more than a 1-day hearing or some schedule set up where you could have more than 5 minutes because I find the questions orally presented and orally answered far better than the written questions and the answers that are given.

Chairman HATFIELD. I appreciate the Senator's point. I find it very frustrating at times as well as unsatisfactory. Yesterday we had a hearing from 9:30 until 1, we had two witnesses during that period of time. We have scheduled two witnesses this morning.

We have two more witnesses coming on another day and we have scheduled at this point four sessions. Now, perhaps we might go to one person per session, but we do have the need to try to get a variety of perspectives.

We are running against that kind of quality of our job. We now have Dr. Rivlin. Next week, Mr. Kelso and Mr. Volcker are scheduled to speak.

So what we try to do is cover much of the spectrum.

Senator DECONCINI. Mr. Chairman, I make no criticism. From this Senator's point of view, I would prefer to have less and more time per witness and I express that as an individual.

Chairman HATFIELD. I think that is an excellent suggestion.

Perhaps next year we will schedule one person from the administration for the entire morning, allotting 10 minutes per Senator.

But you see we have 29 members. I have no way of knowing how many members of the committee will be here, and if we had all members present, 5 minutes per person, 10 minutes per person, we would not get through one witness the whole morning. We were planning in the dark.

# CONGRESSIONAL BUDGET OFFICE

## STATEMENT OF ALICE M. RIVLIN, DIRECTOR

## ACCOMPANIED BY JAMES BLUM, ASSISTANT DIRECTOR FOR BUDGET ANALYSIS

### INTRODUCTION OF WITNESS

Chairman HATFIELD. Dr. Rivlin, would you care to come forward?

It is a pleasure to welcome you back before this committee. Your appearance this year is especially important, since today you are presenting CBO's reestimate of the President's budget, prepared this year at this committee's request. We are of course most interested in hearing this assessment.

As always, the reestimate has been prepared under very trying time constraints. The budget itself was issued on February 8, after months of work by thousands of people in the executive branch. Two weeks is not much time to have to prepare an entire new look, and I know it has meant long hours for you and your staff.

But I do want to tell you on behalf of the Appropriations Committee, that your response to our request is deeply appreciated. We are very anxious to hear the results of the reestimates at this time.

I have had the privilege of seeing your testimony, some parts of it, at least the highlights. You may summarize or highlight as you wish and the entire statement will be placed in the record.

Ms. RIVLIN. Thank you, Mr. Chairman, I'm delighted to be here, I have with me at the table James Blum, who is our Assistant Director for Budget Analysis, and who put in some of the long hours that you were mentioning to prepare this document.

Let me perhaps skip some parts of the beginning of the statement, though I will summarize it and then cover the rest in detail.

The statement covers four major topics. First, the prospect of large and growing budget deficits under existing tax and spending policies, even after the economy recovers from the current recession. Second, the administration's proposed budgetary program for dealing with this potential chronic deficit problem. Third, the results of CBO's technical analysis of the President's 1983 budget. Fourth, some major risks that are inherent in the Administration's proposals.

### THE BUDGET OUTLOOK UNDER CURRENT POLICIES

The budget outlook under current policies, as you know, is, by everybody's calculations, for increasing deficits in the future. That is graphically shown in figure 1, which shows CBO's baseline projections through 1985. The figure shows that the outlook for the budget has changed drastically from what it always used to be when budgeteers looked ahead. The traditional budgeteer's look forward at a budget was always that revenues would rise faster than the gross national product—GNP—as the income tax brought in more revenue under the impact of a growing and inflationary economy, and that in general outlays would rise about as much as the GNP. That situation has been changed by the Economic Recovery Tax Act. Now as we look ahead and as the administration looks ahead, and this point is not in contention, the gap widens. Revenues rise slower than the GNP, outlays rise at about the same rate, and the gap widens from about 2 percent of the GNP for the deficit in 1981 to roughly 5 percent in 1985.

The administration's current policy or current service projections are a little different from ours but the pattern is the same, the pattern of increasing deficits.

## THE ADMINISTRATION'S BUDGET PROPOSALS

The administration has proposed a package of proposals to reduce the deficits over the next several years. If these proposals are adopted, the administration projects that the deficit will decline from about $100 billion in 1982 to $72 billion in 1985. Relative to GNP, however, the reduction in the deficit would be larger, as shown in figure 2.

The administration's proposed budget changes priorities. It increases the real growth in defense rapidly. It does not contain proposals for cutting social security, which means that benefit payments to individuals will continue to account for about one-half of total outlays. Because of the rising deficits and high interest rates, it necessarily contains increases in payments for interest. Finally, it cuts back on the rest of the budget, as is shown grapically in figure 3.

These changes would change the composition of Federal spending quite dramatically over time, as is illustrated in figure 4. Between 1980 and 1985, Defense's share of the budget would grow from about a quarter to a little over a third, payments for individuals would stay at about half, the interest payments would grow, and the rest of the budget would decline very substantially.

## CBO ANALYSIS OF THE PRESIDENT'S BUDGET

Turning to the CBO analysis of the President's budget, we have examined the President's numbers, both in terms of our differing economic assumptions and in terms of our technical reestimates of the President's spending rates.

The CBO's analysis of the President's February budget finds that revenues will be slightly lower than estimated by the administration for 1983–85, and budget outlays will be higher. This finding results from CBO's technical analysis of the administration's budget estimates and a substitution of CBO's economic assumptions for the administration's.

These reestimates produce a dramatic change in the outlook for the budget deficit under the administration's policy proposals. Instead of declining at a moderate rate, CBO's technical and economic reestimates suggest that the deficit would rise steadily from $111 billion in 1982 to almost $140 billion in 1985—almost twice the level projected by the administration. This result is shown in figure 5.

Over the 3-year period, 1983 to 1985, CBO estimates that the President's budgetary proposals would result in budget deficits that exceed the administration's estimates by more than $140 billion. Almost $100 billion, or about 70 percent, of these higher deficits results from technical estimating differences. The CBO technical reestimates for revenues amount to $34 billion and result mainly from different estimates of the revenue effects of the 1981 Tax Act.

On the outlay side, CBO's technical reestimates add an average of more than $20 billion to the administration's budget estimates during 1983–85. The major reestimates involve the cost of farm price supports, which have escalated rapidly in the last few months; the rate of spending for defense procurement activities; likely receipts to be derived from the administration's plan to accelerate leasing of Outer Continental Shelf—OCS—lands; and net interest costs.

### REESTIMATE FOR FARM PRICE SUPPORTS

The CBO technical reestimate for farm price supports is based on more recent information about the outlook for farm production and commodity prices than was available for the administration's budget estimates. The outlook has changed greatly in the last 2 months, resulting in a substantial increase in the demand for Government crop loans. CBO estimates that the effect of bumper crops and lower prices will be to increase net outlays for farm price supports by over $5 billion in both 1982 and 1983, and by another $5 billion spread over the next 2 years.

The CBO continues to expect spending for defense procurement to proceed at a somewhat faster pace than the administration, especially spending from funds already appropriated. The CBO bases its judgment on analyses of historical spending patterns and careful monitoring of emerging trends. Last year, CBO's outlay estimates for procurement proved to be more accurate than the administration's, and spending to date has been consistent with our 1982 estimates.

Estimating receipts to be derived from the sale of OCS leases is very uncertain. Actual bonus receipts derived from individual sales vary widely from expected levels. Nevertheless, the administration's estimates of OCS receipts—totaling $18 billion a year for the next 3 years—appears to be overly optimistic. Based on past experience with this program, discussions with industry experts, and the outlook for world oil prices, the CBO estimates that OCS receipts derived from an accelerated schedule will be on the order of $13 billion in 1983 and 1984, and $15 billion in 1985.

The technical reestimate for net interest largely reflects the cost of servicing the higher deficit levels that would result from using CBO's technical reestimates for both revenues and outlays. The increased interest cost of these higher deficits rises from $2.8 billion in 1983 to almost $10 billion in 1985.

Another $44 billion of higher projected deficits during 1983–85 results from using CBO's baseline economic assumptions instead of the administration's. These higher deficits result almost entirely from higher outlays; there would be little change in revenues under CBO's economic assumptions from those projected by the administration.

### ECONOMIC ASSUMPTIONS

The economic forecasts of both the administration and the CBO are in close agreement for 1982. Real GNP is projected to rise by about 3 percent over the calendar year, and the unemployment rate is expected to be in the neighborhood of 8½ percent at year's end. The forecasts of inflation and short-term interest rates are also similar.

In 1983, however, the administration's forecast for inflation and real growth is more optimistic than CBO's. While both forecasts imply virtually the same expansion of nominal GNP, the administration looks for real GNP to grow by 5.2 percent over the four quarters of 1983, and for inflation—as measured by the GNP deflator—to fall to a rate of 5.5 percent. The CBO, in contrast, expects real GNP to grow by about 1½ percentage points less than the administration does in 1983, and the GNP deflator to rise by about 1½ percentage points more. The slower growth expected by the CBO results largely from the higher interest rates in its forecast, which would dampen the recovery in economic activity.

The administration's economic assumptions for 1984–87 are near the upper end of historical experience. In comparable 4-year periods following previous postwar recoveries, real economic growth averaged 3.4 percent a year and ranged between 2 and 5.2 percent a year. The administration assumes an average growth rate of 4.6 percent a year between 1984 and 1987. The CBO, in its baseline projections, assumes an average annual growth rate of 3.5 percent.

### SOME MAJOR RISKS

Several risks are inherent in the administration's budget proposals. One is that the administration may have underpriced its projected defense appropriation requests. CBO has identified two major elements of concern in this regard. First, inflation may not decline as rapidly as assumed for the administration's budget estimates. With higher than anticipated inflation, the administration would either have to scale back its planned defense purchases to stay within available funds or seek additional funds to complete the planned purchases. The CBO reestimates of the President's budget did not adjust the President's projected budget authority for defense programs for the higher inflation contained in the CBO baseline economic assumptions—that is, the CBO did not assume that the administration would hold to its purchase plans. If this were done, $61 billion in additional appropriations would be needed during the next 5 years to achieve the administration's real growth proposals.

Second, the real cost of defense purchases has grown in recent years—averaging about 3½ percent per year since 1975. This has occurred for a variety of reasons, including program changes—such as new specifications for weapons or revised production schedules—and underestimates of real resources—such as manufacturing hours and materials costs. If the administration is unable to curb this cost growth, further funds would be needed to meet its defense procurement objectives. If the 3½ percent average annual cost growth continues, for example, CBO estimates that an additional $48 billion in new budget authority would be required to fund major weapons procurement during 1983–87.

A second risk is that the administration may not be successful in meeting all of its targets for revenue increases and outlay savings from various management initiatives. CBO has not been able to develop its own independent estimates for outlay savings from several of these initiatives, particularly those that are clearly targets and are not allocated to specific budget accounts. The unallocated targets for reduction of waste, fraud, and abuse; for improved debt collection; and for the sale of surplus or underused Federal property total $16 billion over the 1983–85 period. Based on historical experience, these targets are very optimistic.

A more fundamental risk, of course, is the uncertainty in the economic outlook. The administration's program implies a strong fiscal stimulus in 1982 and 1983. The large budget deficits estimated by the administration and the even larger deficits projected by the CBO would result in a marked increase in Treasury borrowing that would put further upward pressure on interest rates. At the same time, the Federal Reserve's targets for monetary growth may act as a brake on economic growth during the next few years.

## INTEREST RATE PREDICTIONS FOR 1983

Given the combination of monetary and fiscal policies and the projected economic recovery, high interest rates next year seem likely—although the level is hard to predict because this policy combination of a tight monetary policy and a stimulative fiscal policy is virtually without precedent. Nevertheless, there is a significant risk that the outcome could be weaker growth than projected by either the administration or the CBO.

Since budget estimates are very sensitive to economic assumptions, policymakers must be prepared for the possibility of developments markedly different from those assumed by both the administration and the CBO. To illustrate the sensitivity of the budget to economic assumptions, the CBO has also reestimated the President's February budget using a more pessimistic set of economic assumptions. The CBO pessimistic assumptions are portrayed in figure 6. In these assumptions, real growth averages only 2 percent in 1984–87, unemployment remains above 7 percent until the end of the period, and short-term interest rates fall very slowly.

Under this more pessimistic set of assumptions, growth in nominal incomes would be somewhat less and Federal revenues would be lower by about $20 billion during 1983–85 than projected by the administration. The effect on outlays, however, would be much greater. By 1985, outlays would be over $50 billion higher than projected by the administration, and for the entire 3-year period they would be more than $100 billion higher. The effect of using the CBO pessimistic economic assumptions together with CBO's technical reestimates would be to raise the estimated deficit levels under the administration's proposals to $132 billion in 1983, $155 billion in 1984, and $184 billion in 1985.

Let me emphasize, this is not our preferred projection, but it is a way of showing what might happen if things don't develop as well as the CBO and the administration think.

## CONCLUSION

This is a very grim outlook for the budget. If the prospective rise in the Federal budget deficit were exclusively, or principally, a temporary cyclical phenomenon, there would be little cause for concern. Indeed, rising budget deficits during periods of recession serve to limit both the magnitude and the duration of the decline in economic activity. Once recovery is underway, the recession-induced bulge in the deficit disappears as tax revenues grow and as outlays for unemployment compensation and related programs decline.

Unfortunately, the budget problem facing the U.S. Congress is not recession-related. It is, rather, a problem of continuing large and growing Federal deficits into the foreseeable future. Even with good economic growth, the problem of chronic budget deficits is not new, as evidenced by the fact that the Federal budget has been in deficit for 19 out of the last 20 years. However, the difficult economic and budget issues raised by these earlier deficits pale by comparison with the problems that face the country today. No clear economic rationale exists for the persistence of deficit spending year after year, and the distinct possibility exists that large and rising budget deficits could seriously impair the overall performance of the economy over the longer run.

To reduce the risk of continued economic instability, both in the near term and in the longer run, the Congress may wish to consider possible alternatives to the President's budgetary proposals. The CBO has laid out a series of possible strategies and options for reducing the Federal deficit in part III of our annual report to the Budget Committees—Reducing the Federal Deficit: Strategies and Options.

## PREPARED STATEMENT

Mr. Chairman, at this time I request that my prepared statement be inserted in the record.

Chairman HATFIELD. Without objection.

[The statement follows:]

# PREPARED STATEMENT OF ALICE M. RIVLIN

Director
CONGRESSIONAL BUDGET OFFICE

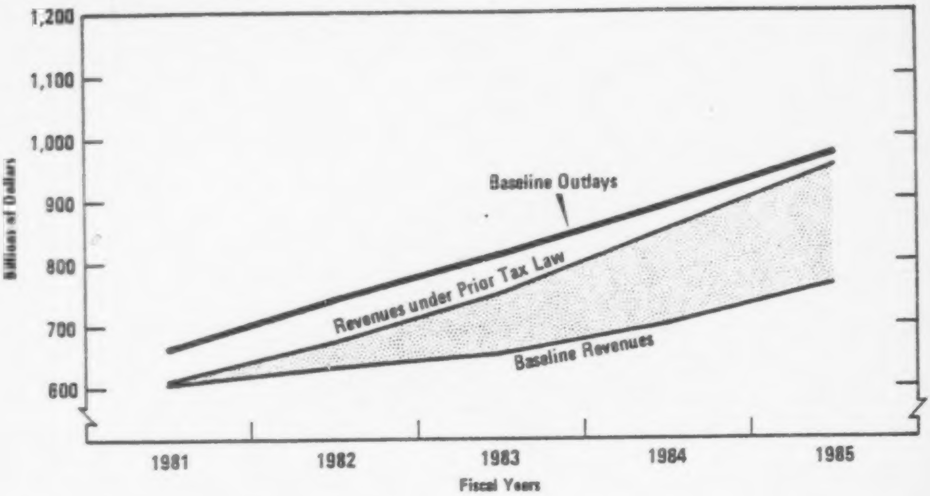
Mr. Chairman, I am pleased to appear before this Committee as you prepare to make specific decisions on the Administration's appropriation requests for fiscal year 1983 and proposed supplementals and rescissions for the current fiscal year. The Congressional Budget Office (CBO), at the request of this Committee, has prepared an analysis of the President's February budget. Copies of that analysis have been distributed to the Members of the Committee and my statement this morning will summarize its findings. I will cover briefly four major topics:

- The prospect of large and growing budget deficits under existing tax and spending policies, even after the economy recovers from the current recession;
- The Administration's proposed budgetary program for dealing with this potential chronic deficit problem;
- The results of CBO's technical analysis of the President's 1983 budget; and
- Some major risks that are inherent in the Administration's proposals.

## THE BUDGET OUTLOOK UNDER CURRENT POLICIES

The budget deficit for fiscal year 1982 is now expected to exceed $100 billion. The sharp rise from the target of $38 billion set by the Congress in its budget resolutions last year can be attributed largely to the current recession. Although most economic forecasters--including the CBO--expect that the economy will begin to recover this year and move into a period of continued growth, budget projections by both the Administration and the CBO show steadily rising deficits under existing tax laws and current spending policies. This prospect for a growing budget deficit is illustrated in Figure 1, which depicts the CBO baseline budget projections through 1985.

Figure 1.
CBO Baseline Budget Projections



SOURCE: Congressional Budget Office.

The CBO baseline budget projections have changed 180 degrees from previous projections, which always showed revenues growing faster than outlays and the budget moving toward a surplus within two or three years. The reason for this change is quite simple. Last year, the Congress enacted the Economic Recovery Tax Act of 1981 which provides for major reductions in individual and corporate income taxes. The effect of the tax act will be to reverse the trend of a growing federal tax burden. Between 1976 and 1981, federal revenues rose from 18.2 percent of the gross national product (GNP) to 21.0 percent of Gross National Product (GNP). Under current tax law, both the Administration and the CBO project a decline in revenues relative to GNP to under 19 percent by 1985.

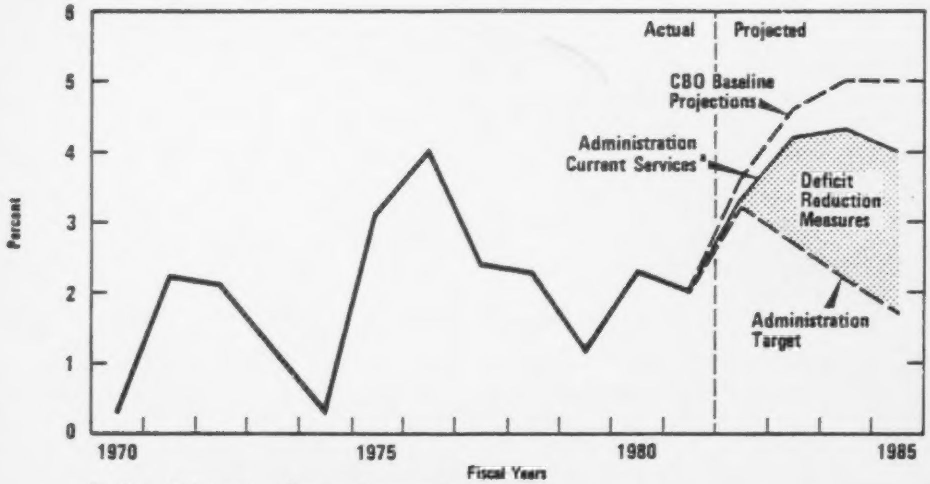
The price of this reduction in the tax burden, however, is a widening gap between revenues and outlays. Figure 1 illustrates that revenues under prior tax law would have been sufficient virtually to eliminate the projected deficits by 1985. Under current law, however, the deficits are projected almost to double during the next three years, rising from about $110 billion in 1982 to $208 billion in 1985.

## THE ADMINISTRATION'S BUDGET PROPOSALS

The President's 1983 budget includes a package of proposals designed to reduce the federal deficit gradually over the next few years. If these proposals are adopted, the Administration projects that the deficit would decline from about $100 billion in 1982 to $72 billion in 1985. Relative to GNP, however, the reduction in the deficit would be much larger, as shown in Figure 2. The Administration estimates that its deficit reduction measures would reduce the relative size of the deficit from 3.2 percent of GNP in 1982 to 1.7 percent in 1985. In the absence of these or other policy changes, the deficit would widen to as much as 4 or 5 percent of GNP.

The Administration's budget and proposed deficit reduction measures continue the policies that the Administration recommended, and that were in large part enacted, last year. Defense appropriations would grow rapidly in real terms. The major individual income tax reductions scheduled for this year and next would be left unchanged. Revenues would be only modestly increased relative to baseline levels, primarily through the elimination of tax provisions benefiting a few specific industries and through improved collection of existing taxes.

Figure 2.
Federal Budget Deficit as a Percentage of GNP

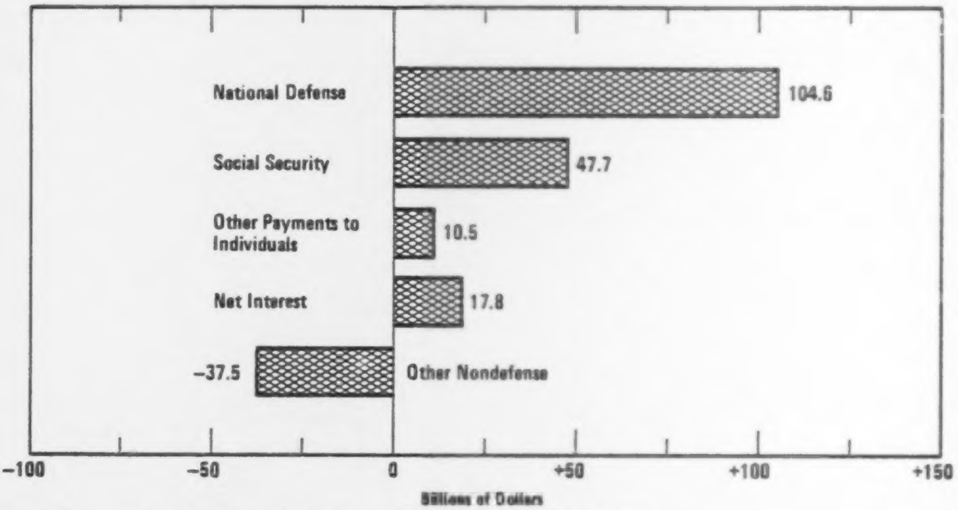


[a] Includes Administration defense spending proposals.

SOURCES: *Budget of the United States Government, Fiscal Year 1983*, p. 3-8, and Table 21, p. 9-60; Congressional Budget Office, *Baseline Budget Projections for Fiscal Years 1983-1987* (February 1982).

Because no major revisions are proposed to the upward path of defense spending or in the personal tax cuts, the planned reduction in the deficit would be achieved primarily through a reduction in spending. The Administration estimates that its deficit reduction measures total about $240 billion over the 1983-1985 period, of which $188 billion--or close to 80 percent--would consist of reduced spending from projected current services levels. The proposed spending reductions do not touch Social Security cash benefits, the largest single nondefense spending program. Interest costs on the national debt depend on the level of debt outstanding and on market interest rates and cannot be directly affected by policy changes. As a result, the proposed spending reductions would cut deeply into federal grants to state and local governments and into spending on the day-to-day domestic operations of the federal government. This is portrayed graphically in Figure 3, which shows the major changes in outlays between 1982 and 1985.

Figure 3.
Proposed Change in Outlays Between 1982 and 1985



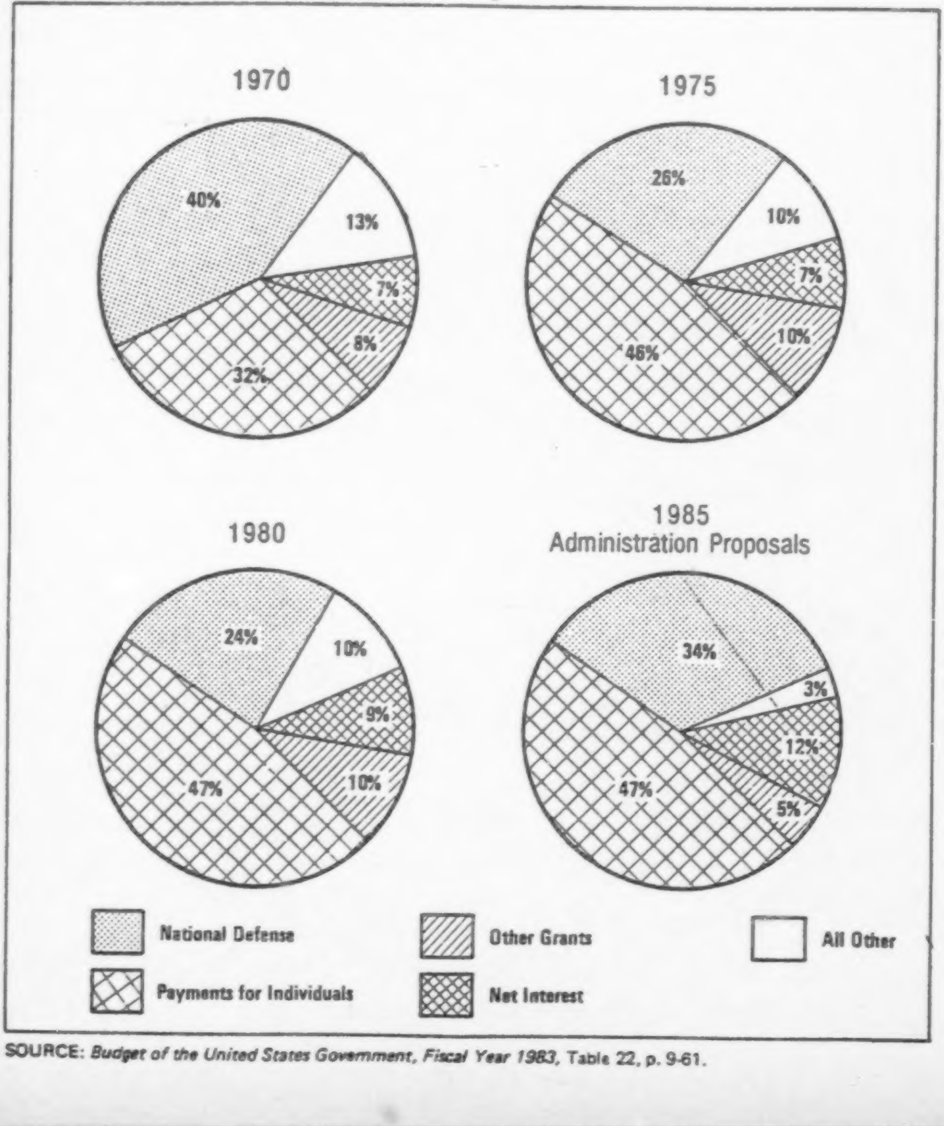
SOURCE: *Budget of the United States Government, Fiscal Year 1983*, p. 3-21.

Under the Administration's proposals, defense spending would rise by over $100 billion--from $188 billion in 1982 to $292 billion in 1985--an average rate of increase of about 16 percent a year. Outlays for Social Security benefits would increase by $48 billion, from $155 billion in 1982 to over $200 billion in 1985.

Other benefit payments to individuals would fall in 1983 and grow only very slowly in 1984 and 1985, as a result of benefit cutbacks proposed by the Administration. Net interest costs would continue to rise, although not as rapidly as in the recent past. The remainder of nondefense spending, particularly grants to state and local governments, would bear the brunt of the Administration's budget reduction measures. Over the 1982-1985 period, this category of outlays would fall by more than a third in current dollars and by almost a half in real terms.

As a result of these proposed changes in outlays, the composition of federal spending would be changed sharply, as illustrated in Figure 4. By 1985, defense

Figure 4.
The Composition of Federal Spending



SOURCE: *Budget of the United States Government, Fiscal Year 1983,* Table 22, p. 9-61.

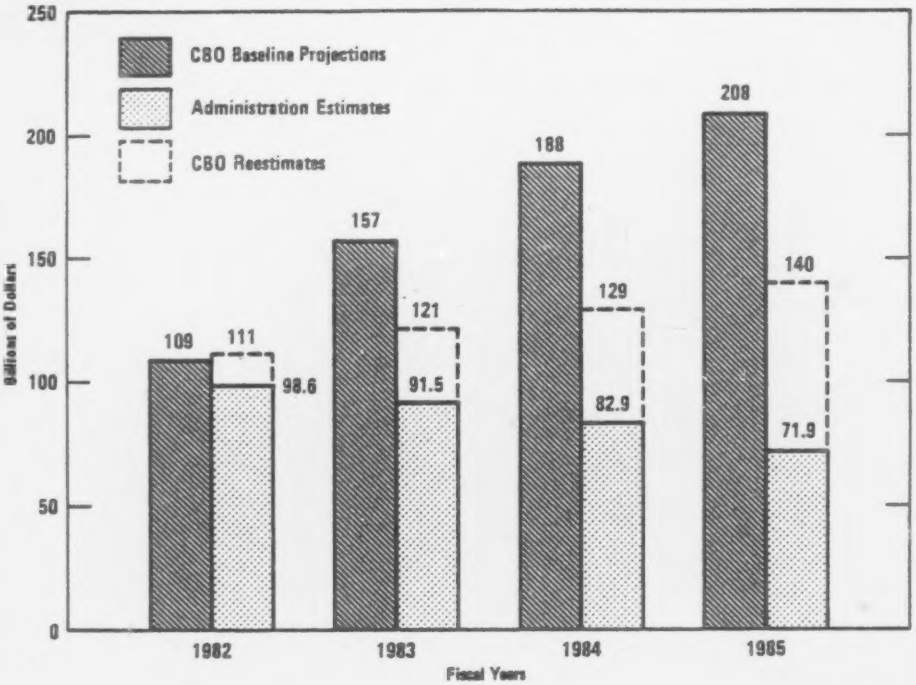
spending would represent 34 percent of the budget--an increase from its 1975 and 1980 levels of about 25 percent, but less than the 1970 level of 40 percent. The share of the budget devoted to Social Security and other benefit payments for individuals, which grew from 32 percent of total outlays in 1970 to 46 percent in 1975, would remain roughly constant at about 47 percent. Net interest costs would grow from 9 percent of the budget in 1980 to 12 percent in 1985. The remainder of the budget, which accounted for about 20 percent of total outlays from 1970 to 1980, would shrink to 8 percent by 1985.

## CBO ANALYSIS OF THE PRESIDENT'S BUDGET

The Congressional Budget Office's analysis of the President's February budget, finds that revenues would be slightly lower than estimated by the Administration for 1983-1985 and budget outlays would be higher. This finding results from CBO's technical analysis of the Administration's budget estimates and a substitution of CBO's economic assumptions for the Administration's.

These reestimates produce a dramatic change in the outlook for the budget deficit under the Administration's policy proposals. Instead of declining at a moderate rate, CBO's technical and economic reestimates suggest that the deficit would rise steadily from $111 billion in 1982 to almost $140 billion in 1985--almost twice the level projected by the Administration. This result is shown in Figure 5.

Figure 5.
Budget Deficits



Over the three-year period, 1983 to 1985, CBO estimates that the President's budgetary proposals would result in budget deficits that exceed the Administration's estimates by more than $140 billion. Almost $100 billion, or about 70 percent, of these higher deficits results from technical estimating differences. The CBO technical reestimates for revenues amount to $34 billion and result mainly from different estimates of the revenue effects of the 1981 tax act.

On the outlay side, CBO's technical reestimates add an average of more than $20 billion to the Administration's budget estimates during 1983-1985. The major reestimates involve the cost of farm price supports, which have escalated rapidly in the last few months; the rate of spending for defense procurement activities; likely receipts to be derived from the Administration's plan to accelerate leasing of Outer Continental Shelf (OCS) lands; and net interest costs.

The CBO technical reestimate for farm price supports is based on more recent information about the outlook for farm production and commodity prices than was available for the Administration's budget estimates. The outlook has changed greatly in the last two months, resulting in a substantial increase in the demand for government crop loans. CBO estimates that the effect of bumper crops and lower prices will be to increase net outlays for farm price supports by over $5 billion in both 1982 and 1983, and by another $5 billion spread over the next two years.

The CBO continues to expect spending for defense procurement to proceed at a somewhat faster pace than the Administration, especially spending from funds already appropriated. The CBO bases its judgment on analyses of historical spending patterns and careful monitoring of emerging trends. Last year, CBO's outlay estimates for procurement proved to be more accurate than the Administration's, and spending to date has been consistent with our 1982 estimates.

Estimating receipts to be derived from the sale of OCS leases is very uncertain. Actual bonus receipts derived from individual sales vary widely from expected levels. Nevertheless, the Administration's estimates of OCS receipts totaling--$18 billion a year for the next three years--appears to be overly optimistic. Based on past experience with this program, discussions with industry experts, and the outlook for world oil prices, the CBO estimates that OCS receipts derived from an accelerated schedule will be on the order of $13 billion in 1983 and 1984, and $15 billion in 1985.

The technical reestimate for net interest largely reflects the cost of servicing the higher deficit levels that would result from using CBO's technical reestimates for both revenues and outlays. The increased interest cost of these higher deficits rises from $2.8 billion in 1983 to almost $10 billion in 1985.

Another $44 billion of higher projected deficits during 1983-1985 results from using CBO's baseline economic assumptions instead of the Administration's. These higher deficits result almost entirely from higher outlays; there would be little change in revenues under CBO's economic assumptions from those projected by the Administration.

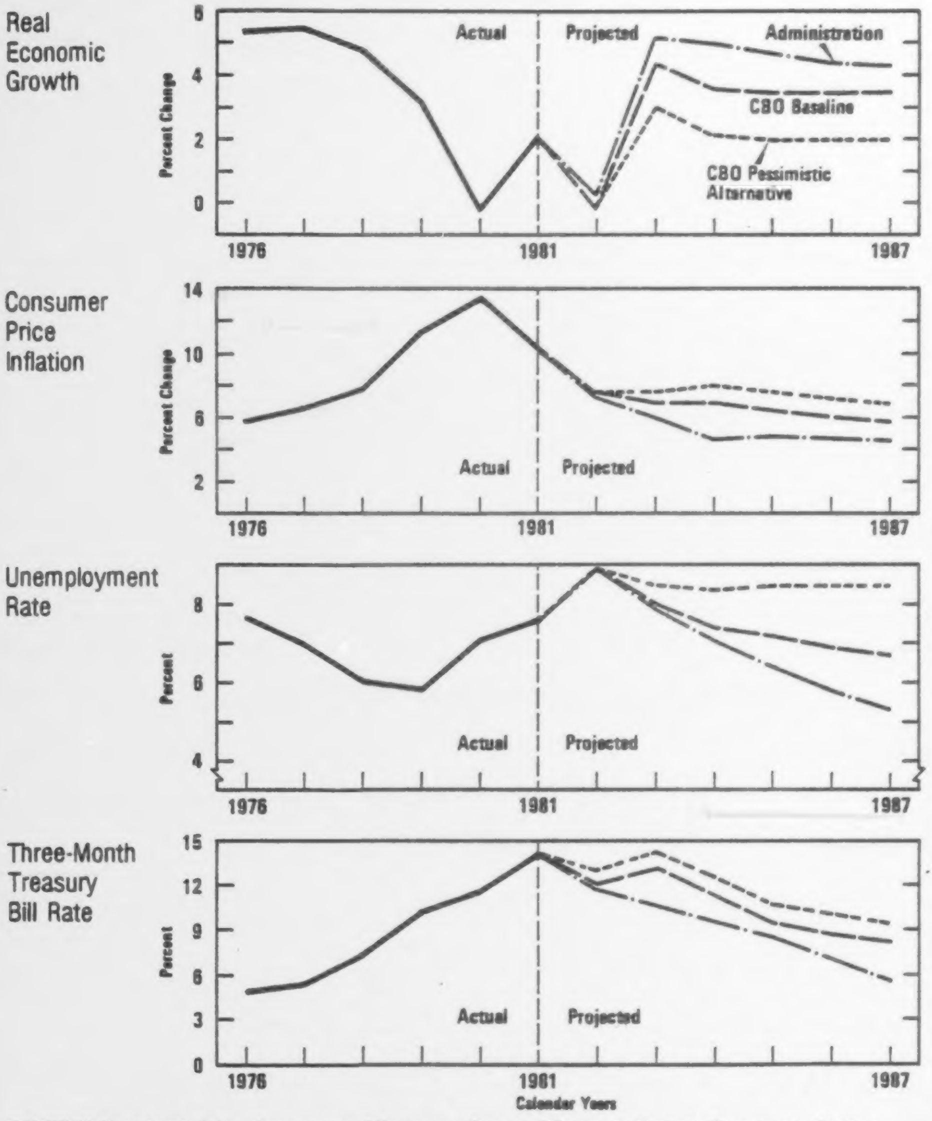
The economic forecasts of both the Administration and the CBO are in close agreement for 1982. Real GNP is projected to rise by about 3 percent over the calendar year, and the unemployment rate is expected to be in the neighborhood of 8½ percent at year's end. The forecasts of inflation and short-term interest rates are also similar.

In 1983, however, the Administration's forecast for inflation and real growth is more optimistic than CBO's. While both forecasts imply virtually the same expansion of nominal GNP, the Administration looks for real GNP to grow by 5.2 percent over the four quarters of 1983, and for inflation (as measured by the GNP deflator) to fall to a rate of 5.5 percent. The CBO, in contrast, expects real GNP to grow by about 1½ percentage points less than the Administration does in 1983, and the GNP deflator to rise by about 1½ percentage points more. The slower growth expected by the CBO results largely from the higher interest rates in its forecast, which would dampen the recovery in economic activity.

The Administration's economic assumptions for 1984 and beyond are also more optimistic than the CBO's, as may be seen in Figure 6. Compared with the CBO baseline assumptions, the Administration projects higher real growth and greater declines in inflation, unemployment, and interest rates.

The Administration's real growth assumptions for 1984-1987 are near the upper end of historical experience. In comparable four-year periods following previous postwar recoveries, real economic growth averaged 3.4 percent a year and ranged between 2.0 and 5.2 percent a year. The Administration assumes an average growth rate of 4.6 percent a year between 1984 and 1987. The CBO, in its baseline projections, assumes an average annual growth rate of 3.5 percent.

Figure 6.
Comparison of Major Economic Assumptions



SOURCES: For historical data, Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; and Federal Reserve System, Board of Governors. For projections, Congressional Budget Office and Office of Management and Budget.

Several risks are inherent in the Administration's budget proposals. One is that the Administration may have underpriced its projected defense appropriation requests. CBO has identified two major elements of concern in this regard. First, inflation may not decline as rapidly as assumed for the Administration's budget estimates. With higher than anticipated inflation, the Administration would either have to scale back its planned defense purchases to stay within available funds or seek additional funds to complete the planned purchases. The CBO reestimates of the President's budget did not adjust the President's projected budget authority for defense programs for the higher inflation contained in the CBO baseline economic assumptions--that is, the CBO did not assume that the Administration would hold to its purchase plans. If this were done, $61 billion in additional appropriations would be needed during the next five years to achieve the Administration's real growth proposals.

Second the real cost of defense purchases has grown in recent years--averaging about 3½ percent per year since 1975. This has occurred for a variety of reasons, including program changes (such as new specifications for weapons or revised production schedules) and underestimates of real resources (such as manufacturing hours and materials costs). If the Administration is unable to curb this cost growth, further funds would be needed to meet its defense procurement objectives. If the 3½ percent average annual cost growth continues, for example, CBO estimates that an additional $48 billion in new budget authority would be required to fund major weapons procurement during 1983-1987.

A second risk is that the Administration may not be successful in meeting all of its targets for revenue increases and outlay savings from various management initiatives. CBO has not been able to develop its own independent estimates for outlay savings from several of these initiatives, particularly those that are clearly targets and are not allocated to specific budget accounts. The unallocated targets for reduction of waste, fraud, and abuse; for improved debt collection; and for the sale of surplus or underused federal property total $16 billion over the 1983-1985 period. Based on past history, these targets are very optimistic.

A more fundamental risk is the uncertainty in the economic outlook. The Administration's program implies a strong fiscal stimulus in 1982 and 1983. The large budget deficits estimated by the Administration and the even larger deficits projected by the CBO would result in a marked increase in Treasury borrowing that would put further upward pressure on interest rates. At the same time, the Federal Reserve's targets for monetary growth may act as a brake on economic growth during the next few years.

Given the combination of monetary and fiscal policies and the projected economic recovery, high interest rates next year seem likely--although the level is hard to predict because this policy combination of a tight monetary policy and a stimulative fiscal policy is virtually without precedent. Nevertheless, there is a significant risk that the outcome could be weaker growth than projected by either the Administration or the CBO.

Since budget estimates are very sensitive to economic assumptions, policymakers must be prepared for the possibility of developments markedly different from those assumed by both the Administration and the CBO. To illustrate the sensitivity of the budget to economic assumptions, the CBO has also reestimated the President's February budget using a more pessimistic set of economic assumptions. The CBO pessimistic assumptions are portrayed in Figure 6. In these assumptions, real growth averages only 2.0 percent in 1984-1987, unemployment remains above 7 percent until the end of the period, and short-term interest rates fall very slow.

Under this more pessimistic set of assumptions, growth in nominal incomes would be somewhat less and federal revenues would be lower by about $20 billion during 1983-1985 than projected by the Administration. The effect on outlays, however, would be much greater. By 1985, outlays would be over $50 billion higher than projected by the Administration, and for the entire three-year period they would be more than $100 billion higher. The effect of using the CBO pessimistic economic assumptions together with CBO's technical reestimates would be to raise the estimated deficit levels under the Administration's proposals to $132 billion in 1983, $155 billion in 1984, and $184 billion in 1985.

This is a very grim outlook for the budget. If the prospective rise in the federal budget deficit were exclusively, or principally, a temporary cyclical phenomenon, there would be little cause for concern. Indeed, rising budget deficits during periods of recession serve to limit both the magnitude and the duration of the decline in economic activity. Once recovery is underway, the recession-induced bulge in the deficit disappears as tax revenues grow and as outlays for unemployment compensation and related programs decline.

Unfortunately, the budget problem facing the U.S. Congress is not recession-related. It is, rather, a problem of continuing large and growing federal deficits into the foreseeable future. The problem of chronic budget deficits is not new, as evidenced by the fact that the federal budget has been in deficit for 19 out of the last 20 years. However, the difficult economic and budget issues raised by these earlier deficits pale by comparison with the problems that face the country today. No clear economic rationale exists for the persistence of deficit spending year after year, and the distinct possibility exists that large and rising budget deficits could seriously impair the overall performance of the economy over the longer run.

To reduce the risk of continued economic instability, both in the near term and in the longer run, the Congress may wish to consider possible alternatives to the President's budgetary proposals. The CBO has laid out a series of possible strategies and options for reducing the federal deficit in Part III of our annual report to the Budget Committees--Reducing the Federal Deficit: Strategies and Options.

## DEFENSE SPENDING

Senator Abdnor [presiding]. Thank you, Dr. Rivlin. For a few seconds I have the gavel in hand. This is the second bell, it was hoped the chairman would return before it became necessary to recess our hearing. We will keep going for just a few minutes.

Here he is.

Chairman Hatfield. Dr. Rivlin, I think probably the most startling aspect of your reestimate is concerning the President's defense program, and I want to quote from page 13, "If CBO reestimated the President's defense program using the higher CBO inflation rate, $61 billion in additional appropriations would be needed during the next 5 years to achieve the administration's real growth proposals."

Then you cite an additional $48 billion of defense appropriations necessary to fund what you call the real cost of defense weapons purchase.

Is it appropriate to add those two figures together and say that $109 billion in additional budget authority is needed to provide the President's defense program?

Ms. Rivlin. It is appropriate to add them. The first figure would result from our higher estimates of general inflation, and the second figure represents additional growth beyond inflation in the cost of individual weapons systems averaging about 3½ percent.

Chairman Hatfield. As you know, the Defense Department has claimed that 93 percent of the fiscal year 1983 outlays are committed to pay, essential operations, and the spendout of prior year appropriations. What is your analysis of the President's estimates regarding these so-called committed outlays?

Ms. Rivlin. I can turn to Mr. Blum for the exact number, but the basic notion is correct. In any given Defense budget, if you exempt pay and the ordinary expenses of running the Department, the procurement spending is mainly from past commitments.

Chairman Hatfield. Doesn't this also have an accumulative impact as it relates to the Pentagon's claim that no outlay reduction is possible in the near term? Isn't it really a reflection of how budget authority provided in prior year appropriations comes back to haunt the Congress as far as getting control of the budget. Isn't that true?

Ms. Rivlin. That is right. Another way of putting it is that no outlay reduction in the future is possible unless you act now.

Chairman Hatfield. One of the serious implications of your analysis stems from the outlays that you assume will be necessary to fund the President's defense program.

Which defense activities are under-estimated?

What proportion, for instance, of all fiscal year 1982 reestimates are those for defense?

Mr. Blum. Mr. Chairman, the proportion is not that large. The spending reestimates for 1983, including the use of different economic assumptions, total something like $23 billion, of which the portion that falls in the national defense category is less than $2 billion. Within that $2 billion, there are some ups and downs. But, by and large, the difference in defense spending stems largely from our different assumptions as to how quickly the procurement of major weapons systems spends out each year.

As you are well aware, these are the long-term investments for which you provide budget authority now and the spending or outlay effects are felt over 3, 4, 5 years or more.

Chairman Hatfield. Your defense outlay estimates are historically different from the Pentagon's estimates. What different methodologies might explain this gap? Also, you indicate that your success rate for estimating defense 1982 outlays was fairly good and you imply it is better than the Pentagon's. Why doesn't the Pentagon adopt some of your techniques? What are the different methodologies?

Ms. Rivlin. I don't know that I can answer that question, Mr. Chairman. The basic methodologies are not different. The only way you have of estimating outlays is to look at historical experience—at how rapidly the programs have spent out, particularly procurement where there is great uncertainty. Over the last several years, we have rather consistently expected them to spend out more rapidly than any administration, and we have been closer on our estimates than they have.

Chairman Hatfield. On procurement?

Ms. Rivlin. On procurement.

### CAUSES FOR HIGH INTEREST RATES

Chairman Hatfield. Secretary Regan stated that interest rates parallel inflation, while Chairman Volcker feels budget deficits strongly affect interest rates. Which is a greater stimulant to the interest rate increase?

Ms. Rivlin. I don't think one can assign a single cause to high interest rates. Certainly tight money in the face of a large government borrowing requirement—or a large private borrowing requirement, if there were one—keeps short-term interest rates up. Interest rates, especially long rates, are also influenced by inflationary expectations, and there is evidence that the continuation of high long rates have been largely because people simply don't yet believe that inflation is coming down as rapidly as most forecasters think it actually is.

Chairman Hatfield. I see my light is on.

Senator Byrd.

### DEFICITS UNDER PRIOR TAX LAW

Senator Byrd. Ms. Rivlin, page 3 of your statement reads as follows, in the first paragraph: "Figure 1 illustrates that revenues under prior tax law would have been sufficient virtually to eliminate the projected deficits by 1985. Under current law, however, the deficits are projected almost to double during the next 3 years, rising from about $110 billion in 1982 to $208 billion in 1985."

Are you saying that had the Kemp-Roth tax cut not been enacted, that the projected deficits by 1985 would have been eliminated?

Ms. Rivlin. Very nearly so. I would emphasize the term "projected" deficits. If we had not had last year's tax cut, projectors looking ahead would have said what they have always said historically, that revenues will rise faster than the gross national product and outlays won't. Therefore the gap will narrow as you look ahead. That would have been the situation if we had not changed the tax law. The projected deficit would have narrowed over time. That is not to say that would have actually happened. But the projection would certainly have been for a virtual disappearance of the deficit by 1985.

Senator BYRD. Had only 1 year of the Kemp-Roth tax cut been enacted, what would have been the impact on the deficit by 1985?

Ms. RIVLIN. It would have been very substantial. The first year as actually enacted was, of course, the smallest cut, the 5 percent. Without the July 1982 and the July 1983 cuts, the deficit would certainly have narrowed by roughly $80 billion.

Senator BYRD. So, you now project as being, what?,

Ms. RIVLIN. It depends on what basis you use. If you were to use the President's budget proposals——

Senator BYRD. Base it on the President's budget.

Ms. RIVLIN. The President's budget proposal shows a deficit of $72 billion in 1985 and our reestimate of that would be about $140 billion in 1985. So, if you were to knock $80 billion off that, it would get you down to roughly $60 billion. These are very rough numbers and one should remember that it is possible that the economic growth pattern would be different under these circumstances.

Senator BYRD. He is saying the deficits would be $98.6 million this year, $91.5 million in fiscal year 1983, and $82.9 million the following year.

Ms. RIVLIN. And $72 billion by 1985.

Senator BYRD. And, as I recall, you are projecting $109 million for this year.

Ms. RIVLIN. $109 billion is our baseline projection for 1982—that is, if current policy remains unchanged. We are saying that the President's budget proposal as reestimated by CBO is about the same, about $111 billion in 1982.

Senator BYRD. What are you projecting for the following year?

Ms. RIVLIN. Our baseline projection, if you don't do anything, would be $157 billion for 1983; the President's budget reestimated by our methodology would be $121 billion.

Senator BYRD. And then for the following year, what are you projecting?

Ms. RIVLIN. Baseline, $188 billion; President's budget reestimated, $129 billion.

Senator BYRD. And in fiscal year 1985 you are projecting $208 million.

Ms. RIVLIN. That is right, and for the President's budget reestimated we are projecting $140 billion.

Senator BYRD. If there would have been just the 1 year tax cut, what would this have done to the budget deficit for those years?

Ms. RIVLIN. Well, by 1984 or 1985 it would have narrowed it by about $80 billion.

Senator **Byrd**. Narrowed?

Ms. **Rivlin**. Yes; increased revenues narrow the deficit.

Senator **Byrd**. So, the deficit would then have been about what?

Ms. **Rivlin**. Well, if you take it off the President's budget, you could get the deficit down to roughly $60 billion by 1985.

Chairman **Hatfield**. Thank you, Senator Byrd.

Senator Proxmire.

### BUDGET PROBLEM NOT RECESSION-INDUCED

Senator **Proxmire**. Dr. Rivlin, I want to congratulate you and thank you for your presentation this morning. It has been a real lesson in economics and economic policy. I have learned a lot from it and I am sure we all have.

I think that the principal message that comes through so loud and clear is that the budget problem, as you say, is not a recession problem. I think many people think of it that way. But even if we do get out of the recession, even if we progress well, even if we have growth, even if interest rates stay down, we are going to have increasing deficits year after year.

Ms. **Rivlin**. That is right.

Senator **Proxmire**. I think this is something that we have to somehow get across. Once we get that across, we can begin to make some real progress on the problem.

Now, you are projecting that even if we put the entire program the President proposes in place, that there will be a rising deficit based on your so-called technical adjustments. In other words, there will be bigger expenditures for such activities as the acquisition of surplus agricultural commodities. I have heard you would have a huge increase in the dairy sector if you abided by the law. Then you have this run-out effect of the Federal procurement expenditures the administration has proposed.

Ms. **Rivlin**. There are both technical reestimates and estimates related to our slightly less optimistic economic outlook.

Senator **Proxmire**. As far as the economic outlook is concerned, I would like you, as a professional economist, to tell us if we have any historical precedents indicating that the Nation can incur deficits of the magnitude you project and at the same time enjoy reduced interest rates, low inflation and substantial economic recovery?

Ms. **Rivlin**. We don't have a historical period that we can point to when there was a rapidly rising deficit in the face of recovery. It seems unlikely that this could occur without rising interest rates. We don't really have a historical precedent for it.

Senator **Proxmire**. It has been said by another economist that we have not had a period with the kind of nominal GNP growth that the administration projects without increasing inflation. Do you think that is a sound judgment or not, assuming nominal growth, because that is the best indicator, rather than real growth.

Ms. **Rivlin**. I think that is right, depending on how long a period you are talking about. There are counterinflationary forces in the present situation that may not have been there in the past.

Senator PROXMIRE. As I understand it, your projected deficit for fiscal year 1983 assumes that Congress will approve the administration's proposed budget cuts of $12 billion in entitlement programs and $14 billion in discretionary programs. We didn't enact in their entirety the cuts the President proposed last September and there seems to be less disposition, perhaps, to support further cuts this year.

What happens to the deficit if Congress fails to make a $26 billion cut in this current budget?

Ms. RIVLIN. Then the deficit is larger.

Senator PROXMIRE. How much larger? Would the deficit be $26 billion greater?

Ms. RIVLIN. It might not be. It would depend on a lot of things about where exactly you didn't change it, but I think roughly speaking, yes.

### INTEREST RATE PROJECTIONS

Senator PROXMIRE. Then you said in your February 5 report on the prospects of economic recovery: "If interest rates fail to decline significantly in the months ahead, standard recovery may not materialize this year."

Do you anticipate a significant decline in interest rates in view of the gloomy deficit picture presented by the President's budget and would it be consistent to have a recovery with the deficits you project without an increase in interest rates?

Ms. RIVLIN. What we expect in our economic projection is that interest rates will come down somewhat over the next year, but that they are likely to come back up again a little bit as recovery proceeds. I think, however, that with large deficits there is a risk that will not happen, that the interest rates may come back up again. It depends on how large the deficit is.

Senator PROXMIRE. How can interest rates decline in light of the very large additional borrowing anticipated by the Federal Government if we also have a recovery, which always is accompanied by additional borrowing in the private sector? Wouldn't that additional pressure be likely to push interest rates up, even if we do have some improvement in savings?

Ms. RIVLIN. We do expect interest rates to come up somewhat in 1983. There are those who expect them to come up dramatically. We don't think that is the most likely prospect.

Senator PROXMIRE. But the core of our problem is in home building, automobiles, and other credit sensitive industries. How can they recover if interest rates come up at all? Interest rates are already so high that there is no way these sectors can expand. The home builders were in to see me yesterday. They say 60 days from now most of them are not going to be in business. They are probably exaggerating but the situation is so bad that if interest rates increases they can't see any increase in housing. There will continue to be terrible unemployment in that industry.

Ms. RIVLIN. Their situation is very serious. The interest rates are a little lower than they were last year. We expect that they will come down further this year, although we have been worried by the fact that recently they were rising.

Senator PROXMIRE. By how much do you expect interest rates will come down?

Ms. RIVLIN. We expect the long rate will come down a little but probably not a lot.

Senator PROXMIRE. How much is a little, 1 percent?

Ms. RIVLIN. Something like that.

Chairman HATFIELD. Thank you, Senator Proxmire.

Senator Stennis.

### REAL GROWTH IN DEFENSE SPENDING

Senator STENNIS. Mr. Chairman, I mentioned earlier to Secretary Regan and this morning about the total military budget and I see here now on this release, it has just been released an analysis of the President's budget proposal for fiscal year 1983, that the Congressional Budget Office—you just released this.

Ms. RIVLIN. That is right. This morning at this hearing.

Senator STENNIS. My attention is called here to page 25, Major Risk, and you refer to that several risks inherent in the administration's budget proposals, one is that the administration may have underpriced its projected defense appropriations request. That identifies the subject there. Let me ask you that general question, you might quote if you wish further.

You say on the next page "If this were done $61 billion in additional appropriations would be needed during the next 5 years to achieve the same real growth in defense spending as proposed by the administration."

We were looking at this this morning with an eye that maybe we ought to take another look at that figure. The military, like I said I am promilitary not anti, and you are saying here now that—interpret a little further what you said?

Ms. RIVLIN. We are saying that we expect that inflation will not come down as rapidly as the administration thinks it will. If we are right, then to buy the same real items—tanks, planes, what have you—that they have in their plan will cost about $61 billion more over the 5-year period than they are estimating roughly.

Senator STENNIS. Your budget has a high figure for inflation. The difference for the 5-year period between your estimates and theirs will total $61 billion in military programs?

Ms. RIVLIN. That is our estimate of the additional cost if they stick with their plan in terms of procurement at the higher cost. Of course, they won't have to do that. They could scale back the items they were going to buy and buy less of them. But if they are going to buy the same real items at the higher inflation, that is how much more it would cost.

Senator STENNIS. So there is no firm and hard reason, then, to make this reduction now by the legislative branch, but that would depend upon those future years and that rate of inflation, is that right?

Ms. RIVLIN. That is right. No one needs to remind you, Senator, that it is important when you are budgeting for defense to have as realistic a view as possible of what the real costs are going to be.

Senator STENNIS. It is certainly well for you to point that out.

I believe that is all I have for the time being.

Senator PROXMIRE [presiding]. Senator Hollings.

### NET INTEREST COSTS

Senator HOLLINGS. Thank you.

That chart that you use, at figure 5, I think is very, very dramatic.

While they are talking about bringing the deficit down to $75 and $85 billion, actually in the education area, we tried to save $16 billion and the chairman of the Education Committee said no more cuts in education. The chairman in Finance said no more cuts. I have to agree with them.

The whole theory of the administration is that if we withdraw the resources of the Government, the Government would be forced to cut spending, that is not occurring and for good reason. That is another debate; that is a matter of policy. Financially what we see now, if we move to Dr. Rivlin's chart on this interest cost, jumping from 7 to 14 percent of the entire budget is going on the GNP analysis from 2 to 5 percent, going from 2 percent of the GNP to 5 percent.

What I see is interest cost going up. And Dr. Rivlin, you correct me, I got the figure that CBO baseline in 1982 the interest costs were up $23.1 billion. And then there was another increase in baseline figure in 1983 of $28.3 billion and 1984 it is $34 billion.

We struggled at reconciliation and adulterated the entire congressional process to save $35 billion and now we are increasing spending in increments of $30 billion and we are not going to be able to do further cuts. We are in a Catch-22 and we are actually increasing the size of Government, actually what the administration proposed not to do.

Do you have the 1985 increment there, that CBO baseline, as that interest cost goes up and up away. We begin to understand, if we don't take some kind of dramatic action at this point we are going to be locked in and that is what the business community and everybody else is looking at. What is the 1985 increment?

Ms. RIVLIN. The CBO baseline projection for 1985 outlays for interest would be $143 billion. It levels off as a percentage of GNP after that.

Senator HOLLINGS. How did it level off? That was the arithmetic in the sense that 1985 is where we are trying to be by way of indexing the revenue system. We use in 1986, $199 billion in revenues.

Ms. RIVLIN. In our economic assumptions the interest rates do come down over that period, so you have a somewhat lower interest rate albeit a larger debt.

Senator HOLLINGS. I think that analysis that you have given and shown, showing exactly what is really occurring, and the statements made, "No clear economic rationale exists for the persistence of deficit spending," my temptation is to ask if you have met Congressman Kemp.

Ms. RIVLIN. Yes, I have.

Senator HOLLINGS. There are other Senators waiting. I will yield.

Thank you, Mr. Chairman.

### INTEREST COSTS AS A PERCENT OF GNP

Senator BUMPERS. You state in your report that in 1985, revenues as a percentage of GNP under the tax cuts of last summer, will have dropped from 21 to 19 percent by 1985. In a $3 trillion economy that would mean $60 billion if all things were equal; is that correct?

Ms. RIVLIN. Correct.

Senator BUMPERS. Senator Hollings has pointed out that you can't have it both ways, increasing defense spending and cutting taxes and, also, balancing the budget. They are saying the deficit is a smaller percentage of the GNP and, yet, the interest we are going to be paying as a percentage of GNP is going fron 2 to 5 percent by 1985? Isn't that correct?

Ms. RIVLIN. No; you are quite correct that interest as a percent of GNP rises. Roughly speaking, in our baseline—not the President's budget but our baseline—it is 3.4 percent of GNP in 1985.

Senator BUMPERS. As opposed to 2 percent now?

Ms. RIVLIN. It was 2.4 percent in 1981.

Senator BUMPERS. So it is up; how much?

Ms. RIVLIN. One full percentage point from 1981 to 1984.

Senator BUMPERS. Is that a legitimate trade-off, cut taxes by such monumental sums and create deficits of colossal sums which in turn raise the amount of permanent locked-in expenditures with the Government for interest on the national debt?

What is the economic trade-off?

Ms. RIVLIN. It does give you a higher debt service cost clearly, but I don't think that is the most important danger of the deficit. The most important danger is that those higher interest rates not only are a cost to the Federal Government, but they can slow down economic growth for the future for the whole economy.

Senator BUMPERS. Which in turn reduces revenues?

Ms. RIVLIN. Right. That is a risk.

Senator BUMPERS. I guess I better get going.

Chairman HATFIELD. Thank you, Senator Bumpers.

Senator Sasser?

### INTEREST COSTS AS A PERCENT OF THE BUDGET

Senator SASSER. Thank you, Mr. Chairman.

I am somewhat of a disadvantage here. I didn't hear all of Dr. Rivlin's testimony. I did hear enough of it to say that you are a master of understatement. The way you handle some of the problems here, you do it very, very well.

Looking at one of the principal graphs here, referring to figure 4, the draft captioned, "Composition of Federal Spending", I note that in the portion of the graph designated for 1985 that the net interest cost is 12 percent on the debt, up 3 percentage points or up from 9 percent in 1980.

Will this percentage of interest continue to expand in the outyears beyond 1985, that is, the percentage of interest as part of the budget, will that continue to expand beyond 1985 at the same rate it has expanded from 1980 to 1985?

Ms. Rivlin. The numbers in figure 4 are the President's proposals on the administration's own calculations. I don't think that the percentage increases appreciably after 1985 because the President's budget assumes that the deficit is coming down.

However, if you were to look at the President's budget as reestimated by the CBO, the interest costs would actually be a larger percentage of the budget because we think that the deficits will be larger and that the interest rates would be somewhat higher. I believe we calculate that interest costs would be around 15 percent of the budget by 1985 and would continue to increase.

It is sort of a self-generating problem. If you think the deficits are going to be larger, than the interests will increase.

### REESTIMATE OF CBO CALCULATIONS

Senator Sasser. Looking on page 8 of the statement here, the recalculations of the budget deficits, I notice, for example, in fiscal year 1985 that the CBO reestimates calculates the deficits at $140 billion. Is that correct?

Ms. Rivlin. That is right.

Senator Sasser. That is twice as much as the deficit that has been calculated for 1985 by the administration.

Ms. Rivlin. That is right.

Senator Sasser. What accounts for that large difference?

Ms. Rivlin. There are really two things, one is that we have a somewhat different economic outlook and——

Senator Sasser. Your economic assumptions are not as rosy.

Ms. Rivlin. They are not. They are not extremely pessimistic either. We see recovery from the recession and a reasonable growth rate over this period; it is not a disaster scenario by any means. We see slower growth and a slower decline in the inflation and interest rates. That alternative set of economic assumptions adds to the deficit. But there is a second thing. We also see higher spending, quite apart from the different economic assumptions, for technical reasons. These technical reestimates are in defense spending, in farm subsidies, in offshore oil receipts, and in several other things.

### OUTLOOK FOR LONG-RUN GROWTH

Senator Sasser. Doctor Rivlin, in your view, will economic be improved significantly if Congress makes substantial progress or if substantial progress is made in reducing the deficit?

Ms. Rivlin. I think the outlook for long run growth would be substantially improved by the prospects of the deficits coming down rather than up.

Senator Sasser. We had the startling statement made here earlier today, I almost fell out of my chair, by the Secretary of the Treasury and he very candidly said that this administration has chosen to borrow rather than moderate the tax cut and using the projections here, the projections of the Congressional Budget Office, and quite frankly I have more confidence in your projections than I do the projections of the administration, using their projections last year tbey were projecting, as I recall a $45 billion deficit, perhaps, $47 billion—it is going to turn out more in the neighborhood of about $100 billion, if I am not mistaken.

I gather it is the view of CBO and your staff that we would be better off rather than trying to borrow ourselves into prosperity, we would be better off trying to raise revenue, narrow the deficit and move forward in that fashion toward some sort of semblance of economic recovery.

Ms. RIVLIN. Senator, we don't try to tell you how to solve a problem.

Senator SASSER. I wish you would. [Laughter.]

Ms. RIVLIN. We are simply saying that in our estimation the deficits will be larger than the President is anticipating even if he gets his program. That leaves you with the dilemma. And there are only two ways to narrow the deficit—one is to raise revenues and the other is to cut spending.

### BASELINE REVENUES

Senator SASSER. Dr. Rivlin, looking here on page 2, figure 1, of your graph there, the "Baseline outlays," another line captioned "Revenues under prior tax law," and then a third line captioned, "Baseline revenues," in your two revenue lines, the top line would be your revenue line under prior tax law prior to the tax cut, is that correct?

Ms. RIVLIN. That is correct. And the baseline revenues means current law.

Senator SASSER. The baseline revenues means the current law?

Ms. RIVLIN. Right.

Senator SASSER. What accounts for our continued disparity there between baseline outlays and baseline revenues as the line moves on out?

Ms. RIVLIN. The major factor is the reduction in taxes.

Senator SASSER. What happened to supply side? I thought if we cut these taxes we were going to have prosperity around the corner. The Secretary of the Treasury was talking earlier today about incentives, what we need to do is give businesses incentives and give consumers incentives. I thought that is what the $750 billion tax cut was, an incentive to get people to produce and work and expand and this was going to generate more revenues. But looking here at your line, it appears to be running just the opposite direction.

Ms. RIVLIN. Well, let it be said that the President always said that further spending cuts would be needed, and those were in fact incorporated in the last budget resolution. It is just that, with the new outlook for the economy, both ours and theirs, the gap has widened very substantially.

Senator SASSER. You are sort of like the policeman on the old television program "Dragnet," you are here to give us the facts.

Ms. RIVLIN. Right.

Senator SASSER. Thank you.

Chairman HATFIELD. Thank you very much, Senator Sasser.

Once again, Dr. Rivlin, we express our appreciation not only for your appearance but for all the staff backup and staff analysis that went into this testimony today. So please extend to your staff our deep appreciation.

## SUBMITTED QUESTIONS

Because of time constraints during the hearing, the committee will submit questions for your reply. They will be placed in the record at this point.

[The following questions were not asked at the hearing but were submitted to Dr. Rivlin for response subsequent to the hearing:]

## QUESTIONS SUBMITTED BY CHAIRMAN HATFIELD

### Recovery from Recession

Question: Economist Alan Greenspan puts the odds at no significant recovery from the present recession at 1 in 3. What is your judgment on the prospects for no recovery or a very modest one?

Answer: CBO sees only a modest recovery from the present recession compared to historical experience (as documented in our recent report, The Prospects for Economic Recovery). This is because of an expected restraint on real GNP growth as the result of continued Federal Reserve attempts to meet low monetary growth targets. The current recession is partly the result of weakness in interest-sensitive sectors such as housing, autos, consumer durables, business investment, and net exports. Over the last few months, interest rates have risen despite weakened private sector credit demands and reduced inflation. The increase in long rates may reflect expectations of high future inflation brought on by the belief that large future deficits must eventually be monetized by the Federal Reserve--a move which would increase money growth.

CBO's forecast of a moderate recovery depends on the assumption that nominal interest rates will fall, even though real interest rates remain very high. If interest rates do not in fact fall as CBO expects, then there is a significant possibility that the recovery from recession this year will be even weaker, or perhaps that we shall not see a recovery until next year. However, our best guess is still that interest rates will fall this year. Rates have fallen somewhat in recent weeks, though in the light of the extreme volatility of rates in the past two years we caution against giving recent short-term movements in interest rates too large a weight.

Question: The President's budget message makes the following statement: "People's savings are beginning to flow out of unproductive speculation, tangible assets, and other inflation hedges back into the Nation's financial arteries where they will be available to power economic recovery, more jobs, and growing incomes and opportunities." Do you agree?

Answer: We do not have complete information on recent changes in savings flows. However, it is clear that less money is now being spent on housing, which has been the major inflation hedge in the economy. High interest rates, coupled with deregulation of financial institutions and innovations such as All Savers' Certificates, may have increased the percentage of savings flowing through financial institutions. On the other hand, there is as yet no sign that private investment has increased. The federal deficit itself has made increasing calls on private saving, while private investment in productive capital equipment is inhibited by high interest rates and by the lack of demand for the products of private industry.

Question: What differences in effect are there between removing money from the economy by borrowing, and by taxing?

Answer: Money that the government borrows comes at the expense of private spending that is primarily financed by borrowing, mainly business investment and consumer spending for durables. Government tax revenues, by contrast, mainly reduce private spending financed out of current income, such as consumption. Because of the investment effects of government borrowing, the stock of private capital and the level of productivity are likely to be lower in the long run if the government borrows very heavily.

Question: Last year before this Committee, OMB Director Stockman stated that during the 1960s, the federal debt as a percent of the total credit market was about 6 percent, whereas the proportion rose to 14 percent in the 1970s. What are the predicted equivalent figures for 1982, 1983, and over the next five-year period?

Answer: CBO has no forecast of the proportion of all credit advanced that would be absorbed by federal government because the analysis of financial flow that would be required to do this is quite complex. In view of the increase in the ratio of the deficit to GNP that we are forecasting, it seems likely that the "absorption rate"--the ratio of federal government borrowing to total credit raised in nonfinancial markets--will continue to increase, especially if the inflow of savings from abroad is reduced or domestic saving fails to register a sharp increase.

## Interest Rates

Question: In our first day of hearings, Dr. Weidenbaum told this Committee that the large deficit and the fear of larger ones were not responsible for the recent surge in interest rates, rather the erratic and very large growth in the money supply was the primary villain. Secretary Regan recently stated that interest rates parallel inflation, not the deficit. Do you believe there is an inconsistency here? What causes high interest rates, and specifically, what caused the recent surge?

Answer: The pattern of change of interest rates is determined by the patterns of change of the demand for and supply of credit. If the total demand for credit rises relative to the supply of credit, interest rates will rise; and conversely. Changes in the demand for and supply of credit are determined by several factors including, among other things, monetary and fiscal policy initiatives, and inflationary expectations.

The question of concern is this: Does increased borrowing by the federal government to finance enlarged budget deficits drive up interest rates? The answer to this question varies depending on the circumstances:

- A recession-induced bulge in the deficit will normally be accompanied by falling interest rates. This is because the increase in federal government borrowing is more than offset by declines in private sector borrowing; since the total demand for credit falls relative to the supply of credit, interest rates fall.

- A policy-induced increase in the budget deficit will normally be accompanied by upward pressure on interest rates. This occurs because the increase in federal government borrowing is added on top of the policy-induced increase in private-sector borrowing; since the total demand for credit rises relative to the supply of credit, interest rates tend to rise.

- For any given demand for credit, interest rates will be affected by changes in monetary policy. Assuming unchanged inflationary expectations, a policy shift in favor of more rapid money expansion would serve to lower interest rates; a more restrictive monetary policy would serve to raise interest rates.

- If inflationary expectations are sensitive to changed rates of money expansion, slower rates of money growth might well be accompanied by lower, not higher, interest rates; and conversely.

- If increased budget deficits are accompanied by expectations that the Federal Reserve will permit more rapid money growth to accommodate enlarged federal government borrowing, interest rates will rise farther than otherwise insofar as inflationary expectations are heightened.

- In an environment of heightened uncertainty--with respect to such factors as inflation, budget deficits, unemployment, monetary and fiscal policy--interest rates will often increase reflecting the extra "risk" and/or "liquidity" premia demanded by lenders of funds.

It is apparent, therefore, that the forces affecting interest rates are many and varied. Depending on the importance that is attached to the various determinants of interest rates, any number of interpretations can be given of the recent surge in interest rates.

## Inflation

Question: Are we on the road to ridding our economy of the abnormal inflation we have suffered in the past decade, or can the recent drop in inflation be attributed entirely to the economic slowdown and external factors such as the glut in the oil market?

To what extent have Administration policies brought about the reduction?

Answer: Inflation has come down very rapidly in the past few months. The reduction in inflation has been exceptionally large in the homeownership, food, and energy cost areas, but it is much more widespread than that. The CPI over the 3 months ending January of this year increased 4.8 percent at an annual rate. Leaving out the impact of food, energy, and homeownership, it increased at about a 6-1/2 percent rate, perhaps two percentage points below the comparable figure for the first half of 1981.

The slowing of inflation is directly related to recession:

- o Mortgage rates remain very high, but have fallen from their stratospheric levels of three or four months ago. This reduces the CPI.
- o The collapse of the housing market has meant small increases, and in some instances actual decreases, in house prices.
- o The recession, both in the United States and overseas, has been an important factor in the unexpected reduction in oil demand and hence in the current oil glut.
- o Poor auto sales have induced auto companies once again to offer rebates. This strategy has had only temporary success in the past in increasing car sales, but it temporarily reduces the growth of the CPI.
- o Other prices, too, have slowed down, as a result of reductions in profit margins in response to poor sales, and also of the strengthening of the U.S. dollar.

It is not yet clear to what extent the slower rate of price inflation reflects slower growth in underlying costs, particularly wage costs. Currently available statistics show some reduction in wage growth, and there are hopeful signs in the union wage sector. For the first time, contract reopenings have been a significant moderating factor.

Much of this decline in inflation is clearly due to the current recession, and hence to the combination of economic policies that produced the recession. CBO argued in its February economic report that the proximate cause of the recession was high interest rates, caused in part by the slow growth of the money supply. Tight monetary policy is the responsibility of the Federal Reserve rather than of the Administration.

## Monetary Policy

Question: One Wall Street economist has stated that while the whole thrust of fiscal policy is expansive, monetary policy is anti-growth, and that this contradiction has resulted in the punishing level of interest rates and the present recession. Do you believe this is an accurate assessment?

Answer: Current monetary policy is certainly consistent with weak economic growth, given the announced targets for the monetary aggregates and the slow rate at which wage and price advances are expected to respond to current policies. Much, if not most, of the current recession can be attributed to tight monetary policy. However, the explanation of the current high level of interest rates, when the real demands of the economy are quite modest, is somewhat of a puzzle. This is discussed above, in the question on interest rates.

Fiscal policy is expansive, although it should be remembered (1) that a portion of this policy is directed at stimulating investment, raising productivity, and thus reducing inflationary pressures over the years ahead; and (2) that substantial slack now exists in the economy. In a world without inflation, the current mix of policies would result in robust growth. The problem for policymakers is moving the economy to low inflation as quickly as possible, with the correct mix of policies and the least amount of side effects. This is not an easy task and the outcome of the current policies is difficult to predict.

With current policies, the CBO forecasts a recovery during the second half of this year and into 1983 that is weaker than the typical cyclical recovery. However, there is a significant risk that fiscal policy may become too stimulative over the next few years, particularly as the economy begins to move into the later stages of the expected recovery. Continued high levels of federal government borrowing will likely keep interest rates high, thus choking off private investment and constraining interest-sensitive sectors of the economy, such as housing and autos, to their current dismal state. This result would not only worsen the short-run outlook but would delay substantially the intended benefits of the Economic Recovery Tax Act.

## General

Question: Last year, OMB Director Stockman attacked the frequent changes in outlay and revenue estimates, as creating a significant decline in confidence of the management of the nation's finances. How would you rate the Reagan Administration's performance in this regard?

Answer: Changes in outlay and revenue estimates are a fact of life. Since the federal budget is affected so much by economic conditions, a change in the economic outlook or in actual economic conditions can have a major impact on budget estimates. For example, the current recession was not anticipated last year by the Administration or by the Congress. The impact of the recession has been to lower estimated revenues and to raise outlays. The impact on the budget deficit for 1982 is quite large. This is not a new phenomenon. Unexpected recessions have occurred before, with much the same results for the federal budget. Therefore, I would not rate the Reagan Administration's performance as being any better or worse than previous administrations with respect to the accuracy of budget estimates.

## Investment

Question: Last year, OMB Director Stockman stated that during the first half of the 1960s, federal investment as a proportion of federal expenditures was 40 percent, whereas in the 1970s, the figure was only 15 percent. What is the equivalent figure for 1982, 1983, and for the next five-year period?

He termed this process capital consumption, rather than capital expansion, and stated that the U.S. "through the breakdown of its fiscal policy, has embarked on the dangerous path of consuming its own capital and living off its own savings." Has the Reagan Administration been able to alter this situation?

Answer: The 15 percent share of federal outlays spent for investment purposes in the 1970s refers to spending for civil investment-type programs as a percent of total budget outlays. In addition, the federal government spent additional amounts for investment-type programs associated with national defense. In fiscal year 1975, civil investment-type spending was 15.2 percent of total outlays while investment-type spending for defense was 8.9 percent.

Relative to 1981, total investment-type spending as a share of total outlays is projected to fall by several percentage points in fiscal years 1982 and 1983, with the relative composition shifting from civil to defense purposes, in accordance with the Administration's budget priorities. (See the following table.) Estimates for the period beyond fiscal year 1983 are not available.

PERCENT OF TOTAL BUDGET OUTLAYS

| Fiscal Year | Investment-Type Programs | | | Current Programs | | | Unclassified and Other | | |
|---|---|---|---|---|---|---|---|---|---|
| | Total | Civil | Defense | Total | Civil | Defense | Total | Civil | Defense |
| 1975 | 24.0 | 15.2 | 8.9 | 80.1 | 61.0 | 19.5 | -4.6 | -2.9 | -1.8 |
| 1981 | 22.2 | 13.6 | 8.6 | 80.8 | 65.1 | 15.7 | -3.0 | -3.0 | 0.0 |
| 1982 a/ | 20.4 | 11.1 | 9.3 | 82.3 | 65.7 | 16.6 | -2.7 | -2.7 | 0.0 |
| 1983 a/ | 20.5 | 9.1 | 11.4 | 83.4 | 65.6 | 17.8 | -3.9 | -3.9 | 0.0 |

NOTE: Investment-type programs are those that yield benefits in future years through the acquisition of physical or financial assets, or through expenditures for less tangible long-term benefits such as education. Current programs provide benefits primarily in the year in which the outlays that finance them are made. Outlays or offsetting receipts that cannot be identified as either investment or current in nature are called unclassified; they include allowances, employer share of employee retirement (-), and proprietary receipts from the public (-).

a/ Estimated

The issue of "capital consumption, rather than capital expansion" is very hard to evaluate. Since 1974, more dollars have been spent by the government each year for investment-type programs. Whether or not these spending increases have resulted in net increases in government-associated capital, however, is in dispute. To distinguish between gross investment and net investment is difficult in any case, and even more difficult in the case where spending for such items as research and development or financial investments are included in the total. GAO and OMB have examined these matters in depth; their staffs can provide you with more detailed information.

You might also consult Special Analysis D (Investment, Operating and Other Budget Outlays) of the Budget for 1983. It discusses the conceptual and accounting difficulties associated with estimating a capital budget for the federal government. Examples are the allocation of general revenue sharing funds (which recipients are free to use for current or investment-type purposes); the estimation of the market value of federal buildings, land, and off-shore areas under government control; and the depreciation of government property, especially weapons. Special Analysis D also gives, for fiscal years 1981 through 1983, detailed information on the components of spending for current and investment-type programs.

## Budget Specifics

Question: Reduced Outlay Growth: One of the major themes of the budget is that of the reduced growth of outlays.

To illustrate how the President's budget reduces the growth of outlays, the Carter budget with "adequate defense" has been reconstructed and last year's budget reductions have been compared to this base. The Administration claims that last year's extraordinary reductions brought the growth of outlays down from 12 percent to around 8 percent and 10 percent respectively in fiscal years 1982 and 1983.

Why is it that, in the outyears, the outlays growth rate comparison to the Carter budget (even with "adequate defense") shows that last year's efforts result in even higher outlay growth than before the Reagan program was adopted?

Answer: I believe that you are referring to a table on page 3-6 of the 1983 budget document that shows the outlays impact of enacted and proposed budget changes. We are not sure how the estimates for the "pre-February 1981 baseline with adequate defense" were constructed or how the estimates of enacted changes were derived. Therefore, we cannot give you an exact answer to your question. I would note, however, that the estimated effect of the enacted changes is to lower the levels of projected outlays in 1984-1987 by a relatively constant dollar amount of about $50 billion in each year. This has the mathematical effect of raising the year-to-year percentage growth after the changes are deducted from the pre-February 1981 baseline. In order for the year-to-year percentage growth to be the same or lower, the reductions would have to grow each year after 1983.

Nevertheless, the levels of total outlays are lower for the entire period by a combined total of $269 billion, and the average annual growth rate for the six-year period is lowered from 9.0 percent to 8.2 percent. I believe this is the essential point to be made from these figures.

Question: Pessimistic Scenario: Your statement concludes with the CBO "pessimistic" scenario in which deficit levels could reach $123 billion in FY 1983.

This would be caused by lower GNP, higher interest, inflation, and unemployment. What might be the odds of this scenario coming to pass?

At what point in the year will we be in a position to recognize this pessimistic scenario.

Answer: The current recession is projected by CBO to end during the first half of this year. Following the July tax cut, economic growth is expected to accelerate. The recovery, however, is projected to be less vigorous than the typical cyclical upswing.

Why the weak recovery? The reason is that the Federal Reserve's targets for money growth are so restictive that a sustained period of rapid economic growth is unlikely during the next few years. The Federal Reserve targets seem to be consistent with nominal GNP growth in the 7 to 11 percent range during the next two years. But with inflation expected to be in the 6 to 8 percent range, there appears to be little room for rapid growth in real economic activity. It is possible, of course, that the Federal Reserve will modify its stringent policies, or that historical relationships between money and GNP growth will not hold during the recovery, or that inflation will decline much more rapidly than now seems likely--developments that might be associated with a more vigorous recovery. At present, however, the downside risks appear to be much greater.

Thus, if the Federal Reserve's monetary targets are more restrictive than CBO assumes (the CBO baseline forecast assumes 5.5 percent M1 growth in 1983), if productivity growth continues to remain low, if inflation remains high, or if financial market reactions to the size of current and projected budget deficits are worse than expected, economic conditions for 1983 would be worse than CBO now forecasts. The CBO pessimistic scenario is largely based on these alternative adverse economic conditions.

Although this outcome is not our best guess, the downside risks are substantial. We should be better able to judge the 1983 outlook later this year when the Federal Reserve's position and the credit market's interest rate response to the projected recovery become clearer.

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## QUESTIONS SUBMITTED BY SENATOR HARRISON SCHMITT

### Federal Credit Budget

Question: The federal credit budget for fiscal year 1983 is $147 billion--roughly a 2.5 percent increase over fiscal 1982. When added to the projected $91 billion deficit in the cash budget, federal borrowing in fiscal 1983 appears to exceed $200 billion. Is the government swamping the credit markets?

Answer: The borrowing requirements for the federal government are not calculated by adding the credit budget to the deficit. The credit budget aggregates total new direct loan obligations and total new loan guarantee commitments. These aggregates must be adjusted in several respects in order to calculate related federal borrowing requirements, as follows:

- Federal borrowing to support credit activities is required only to the extent that new loans and loan guarantees exceed repayments. The credit budget is stated in gross terms, total new loans and guarantees rather than net lending.

- Net on-budget direct loans are already included in the cash budget deficit.

- Net off-budget direct loans must be added to the cash budget deficit.

- Net loan guarantees result in borrowing for guaranteed loans.

In the 1983 budget, Table F-1 of Special Analysis F, "Federal Credit Programs," shows federal participation in domestic credit markets. The Office of Management and Budget (OMB) estimates that borrowing for the activities covered by the unified or cash budget and the credit budget in fiscal year 1983 will be $154.6 billion: $108.0 billion for on- and off-budget deficits; and $46.6 billion for borrowing for guaranteed loans. An additional $50.1 billion will be borrowed under federal auspices by government-sponsored private enterprises. The government-sponsored enterprises: for example, the Student Loan Marketing Association (SLMA) and the Federal National Mortgage Association (FNMA) are privately owned and are not included in either the federal unified budget or the federal credit budget. These organizations were originally established by the federal government to increase liquidity within financial markets. The inclusion of this indirect borrowing increases total estimated borrowing under federal auspices to $204.7 billion for fiscal year 1983.

The extent to which federal borrowing affects the credit markets in 1983 will depend upon the health of the economy and the total volume of funds raised in U.S. credit markets. The federal participation rate has varied substantially over recent years from highs of 37.2 percent in 1975 and 40.6 percent in 1976 (recession years), to a low of 19.5 percent in 1979, a year in which the economy performed reasonably well. If the recessionary years are not considered, the direct federal borrowing and borrowing of government-sponsored enterprises are estimated to be substantially higher in 1982 than in recent years. Given the 1982 recession, the federal participation rate in 1982 is likely to relatively high. With economic improvements, it should be somewhat lower in 1983.

Question: What efforts is the Administration making to control the federal credit budget?

Answer: The Administration's revised 1982 and 1983 credit budgets would significantly reduce credit activity for most programs. The 1983 request for direct loans to fund new activities has been reduced by 33 percent from the 1981 actual level. If increases estimated for Veterans Adminstration (VA) and Federal Housing Administration (FHA) mortgage assistance and the guaranteed student loan program are discounted, the 1983 request for the remaining loan guarantee programs would decrease by 25 percent from the 1981 actual level. The reductions are to be accomplished through termination of all lending in some programs and better targeting in others. Chapter II of CBO's report, Federal Credit Activities: An Overview of the President's Credit Budget for Fiscal Year 1983, describes the Administration's 1982 and 1983 credit budget proposals. Chapter IV provides more detailed discussions organized by budget function. A copy of the credit budget report is attached for the record.

Question: Over the next five years, do you foresee a decline in the federal government's share of total borrowing in order to alleviate upward pressure on interest rates?

Answer: Under existing law, future growth in federal revenues will be sharply reduced from rates experienced over the past decade as a result of the tax cuts contained in the Economic Recovery Tax Act of 1981. Without further cuts in spending, budget outlays will grow at a faster rate than revenues. Consequently, without steps to raise revenues or to lower the growth in spending, the budget deficit will continue to grow--and with it, federal borrowing to finance the deficit. This budget outlook is portrayed clearly by both the CBO baseline projections and the Administration's projection of current services (see Table below).

BUDGET DEFICITS: COMPARISION OF CBO AND ADMINISTRATION ESTIMATES (By fiscal year, in billions of dollars)

| | 1981 Actual | Estimates | | | |
|---|---|---|---|---|---|
| | | 1982 | 1983 | 1984 | 1985 |
| CBO Baseline Projections | 58 | 109 | 157 | 188 | 208 |
| Administration Current Services Baseline with Proposed Defense Spending Growth | 58 | 101 | 146 | 165 | 168 |
| Administration Budget Proposals | 58 | 99 | 92 | 83 | 72 |
| CBO Reestimates | 58 | 111 | 121 | 129 | 140 |

The Administration's proposed 1983 budget and estimates for 1984 and 1985 would reduce the projected deficits substantially through spending cuts and revenue increases. Assuming that all the President's legislative proposals for taxes and spending are approved, CBO has estimated substantially higher deficits because of economic and technical reestimates of the Administration's proposals. Over the next five years, CBO foresees an increase in federal borrowing to finance these deficits.

The Administration's budget does not include assumptions beyond 1983 for the credit budget. The policy stated in the Administration's 1983 budget is to reduce the credit budget as a means of relieving upward pressure on interest rates.

Question: What do you think of the idea of offsetting any projected increase in the federal cash budget deficit, over the $91 billion Administration estimate, with further reductions in the federal credit budget?

Answer: There are two factors the Congress would have to take into consideration in order to offset increases in the cash budget with further reductions in the credit budget:

o The credit budget is stated in obligations and commitments rather than disbursements.

- o Legislative control over credit programs is divided between the appropriations and authorizing committees.

The credit budget is stated in terms of direct loan obligations and loan guarantee commitments rather than disbursements. To offset spending, disbursements would have to be reduced, a change that would require larger reductions in some credit programs since only a portion of the new lending actions are disbursed in any budget year. For 1983, disbursements for total direct loans are estimated to exceed new loan obligations by 111 percent and for new loan guarantees will equal 90 percent of total commitments. These averages hide substantial variations among programs in disbursement rates. For example, loan guarantees for the Rural Electric and Telephone Revolving Fund may not be disbursed fully for ten years. Implementing a credit budget offset would require a program by program review of disbursement rates.

The Administration has proposed that a substantial portion of the credit budget for direct loan obligations be exempted from limitation by appropriations: entitlements, financing transactions and default payments. To the extent that the legislation authorizing the activity establishes an entitlement, authorizations would have to be revised in order to reduce the program. Financing transactions must be controlled by limitation on the agency originating the direct loan or the guarantee, not by control of the Federal Financing Bank (FFB). The table below shows the distribution of the credit budget between amounts limited and the amounts exempted from limitation.

DISTRIBUTION OF CREDIT BUDGET REQUESTS BETWEEN THOSE PROPOSED FOR APPROPRIATION LIMITATIONS AND THOSE EXEMPTED (In billions of dollars)

| Credit Activity | No Appropriation Limitation | Appropriation Limitation |
|---|---|---|
| Direct Loan Obligations | | |
| Guarantee claims | | |
| Foreign military sales credit | 0.2 | --- |
| Veterans' housing | 0.8 | --- |
| Small Business Administration business loans | 0.5 | --- |
| Federal Housing Administration | 0.3 | --- |
| Student loan insurance | 0.5 | --- |
| Subtotal | 2.3 | --- |
| Repurchase of loan assets | | |
| Farmers Home Administration | 6.8 | --- |
| Agency-guaranteed loans disbursed as direct loans by the FFB | | |
| Foreign military sales credit | 4.4 | --- |
| Rural Electrification Administration | 4.1 | --- |

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(Continued)

TABLE (Continued)

| Credit Activity | No Appropriation Limitation | Appropriation Limitation |
|---|---|---|
| Tennessee Valley Authority | 5.3 | --- |
| Low-income public housing | 1.0 | --- |
| Other 1.6 | --- | |
| Subtotal | 16.4 | --- |
| Direct loans for new activities | | |
| Loans to foreign countries and U.S. exporters | 0.9 | 6.9 |
| Loans for farmers and rural communities | 6.6 | 5.3 |
| Other 1.0 | 2.8 | |
| Subtotal | 8.5 | 15.0 |
| Total, Direct Loan Obligations | 34.0 | 15.0 |
| Loan Guarantee Commitments | | |
| Primary guarantees | | |
| Federal Housing Administration | --- | 35.0 |
| Veterans' Administration mortgages | 22.4 | --- |
| Low-rent public housing | 18.7 | --- |
| Guaranteed student loans | 10.3 | --- |
| Export-Import Bank | --- | 8.0 |
| Other | 0.8 | 3.2 |
| Subtotal | 52.2 | 46.2 |
| Guarantees originated by the FFB as direct loans | | |
| Foreign military credit sales | --- | 4.4 |
| Rural Electrification Administration | --- | 4.1 |
| Tennessee Valley Authority | 5.3 | --- |
| Low-income public housing | 1.0 | --- |
| Other | 1.6 | --- |
| Subtotal | 7.9 | 8.5 |
| Total, Loan Guarantee Commitments | 60.1 | 54.7 |
| Secondary guarantees | | |
| Government National Mortgage Association | --- | 38.4 |

Question: If the federal credit budget had to be cut another $20 to $30 billion, where would you suggest that the cuts be made?

Answer: Reducing the credit budget by $20 to $30 billion would require difficult choices by the Congress. CBO developed a number of alternative strategies for reducing the credit budget as part of its paper, Reducing the Federal Deficit: Strategies and Options, in Chapter XIII. The following discussion summarizes that chapter.

The Congress may wish to consider ways of reducing federal credit demands that can be used to enhance the efficiency of remaining credit programs. CBO suggested three strategies consistent with an efficient reduction in federal credit:

- Eliminate credit programs in which federal credit duplicates private credit.
- End interest subsidies entirely for some programs by raising interest rates to market levels. If the Congress desires to subsidize certain activities, it may prefer to do so with direct grants.
- Restrict eligibility and loan terms to make the existing programs more cost-effective.

## Credit Duplication

A number of current federal credit programs may duplicate private sector lending. For instance, FHA mortgage insurance was originally designed to correct a gap in private credit markets by extending credit in a form not supplied by private lenders. Until the recent rise in interest rates, the housing market had accepted the long-term, low downpayment mortgage that the FHA pioneered. If patterns of current interest rates do not continue into the future, this program may no longer be needed.

The Rural Electrification Administration (REA) was also designed to meet an earlier credit market gap that may no longer exist--namely, the inability of rural utilities to raise capital to extend electricity to remote areas. Now that almost all homes and businesses have access to electricity, the capital needs of rural utilities may be similar to those of other utilities. Since REA lending is heavily subsidized, however, these utilities would face higher interst costs. Eliminating REA-guaranteed lending programs would reduce federal intervention in credit markets by $5.5 billion in 1983.

The Synthetic Fuels Corporation is an example of a fairly new program planned to override private financial market decisions. Under current policy, synfuel loan guarantees could be extended to oil companies that might not need subsidized credit. Moreover, the increased price of oil resulting from decontrol has improved the competitiveness of synfuels, providing incentives for energy companies to invest synfuels without a subsidy. The Administration has proposed to shift from synfuel loan guarantees to price guarantees, a change that reduces the credit budget by $2 billion in 1982, but may result in substantial uncontrolled outlays in the future.

## Eliminate or Reduce Interest Subsidies

OMB currently estimates that the present value of explicit interest subsidies to the borrowers from 1983 federal credit extensions will be $14 billion. The total subsidy amount is even higher since the government lends to riskier borrowers and projects than those financed by private markets. The Congress should consider whether such large subsidies are required. Reducing interest subsidies would not only lower direct spending but could also reduce demand for federal loans.

Some examples of current interest subsidies for federal credit programs are:

- The Economic Support Fund lends to foreign countries at an average interest rate of 2.8 percent and with an average term of 32 years;
- Direct loans for rural housing are made at an average rate of 3.6 percent for a 37-year term;
- Loans are made to rural electric cooperatives at an average rate of 4.7 percent for a 35-year term; and
- The Bonneville Power Administration is being charged 1.3 percent for a 19-year loan.

These and other examples appear in the following table.

INTEREST SUBSIDIES FOR FEDERAL CREDIT PROGRAMS

| Program | Average Current Interest Rate (In percents) | Average Term (By years) | Present Value of Loans Extended in 1983 (In millions of dollars) a/ |
|---|---|---|---|
| Economic Support Fund | 2.8 | 32.2 | 651 |
| Foreign Military Sales Credit | 12.0 | 8.0 | 278 |
| Agricultural Credit | 9.0 | 7.0 | 1,822 |
| Rural Housing | 3.6 | 37.2 | 2,644 |
| Rural Electric and Telephone | 4.7 | 35.0 | 461 |
| Bonneville Power Administration | 1.3 | 19.5 | 42 |
| Export-Import Bank | 10.5 | 11.0 | 1,275 |
| Guaranteed Student Loans | 9.0 | 12.0 | 3,401 |

SOURCE: Office of Management and Budget.

a/ The interest subsidy is the difference between the interest payments at current rates and the payments that would be required at market rates, converted to a single discounted present value.

### Revise Eligibility Criteria and Loan Terms

If the Congress wished to continue to provide subsidized credit for certain activities, it might choose to target assistance more narrowly. Stricter focusing of eligibility requirements and tightening of loan terms could make existing programs more cost-effective by directing subsidies to those in need of assistance without aiding potential borrowers who have an unduly high risk of default.

Tighter eligibility rules would lead to a smaller number of loans with little diminution in program effectiveness. For example, the government could limit the Aircraft Purchase Loan Guarantee program to airlines serving small communities. By directing loan guarantees to commuter carriers that generally serve communities of less than 5,000 persons and through stipulations on aircraft size, the current $650 million ceiling on loan guarantees could be reduced. (The Administration has recommended eliminating this program.)

The Food for Peace (Public Law 480) credit sales could be limited to countries in which the United States has a strong foreign policy interest or which are experiencing food shortages. The present program frequently provides funds to countries that do not need the commodities urgently but purchase them because of the large subsidy. Similary, loan terms for foreign military sales and economic support loans to middle-income countries could be revised. The loan terms for economic and military aid to U.S. allies are now designed to meet the needs of the poorest nations. But setting lower standards to help these countries also permits such lending to wealthier countries that could borrow at higher interest rates and shorter maturities.

Question: A survey of small businesses indicates, despite recent layoffs, many firms plan to increase hiring during the First Quarter of 1982.

Since the vast majority of jobs are created by small businesses, wouldn't this seem to indicate the unemployment rate may soon begin to decline?

Answer: The recent employment release suggests that the decline in employment may be coming to an end. However, even after the demands for goods and services improve, and production starts to expand, the growth in employment tends to be relatively slow for the first few quarters of the recovery. One reason is that productivity, or output per labor hour, tends to increase rapidly during the early phase of recovery, limiting the early gains in employment. In addition, the average number of hours worked per week increases during the early stage of recovery which further curbs the expansion in the number of jobs. At the same time, the labor force has an upward momentum that continues even during recessions (due to population increase and increases in labor force participation rates). As a result, the improvement in unemployment tends to lag at the turning point of recoveries. For example, in the 1973-1975 recession, the trough occurred in the first quarter of 1975 and yet the unemployment rate peaked during the second quarter. Thus, the CBO forecast calls for a recovery in the growth of real GNP in the first half of this year but unemployment is projected to decline quite slowly to the 7.0 to 9.0 percent range by late 1983.

Question: When do you predict an end to the current recession?

Answer: The recession is projected by the CBO to end during the first half of 1982. The recovery in economic activity is seen as brought about by more moderate interest rates, declining inflation, and the tax cuts enacted in 1981. The projected recovery, is less vigorous than the typical cyclical upswing. The reason? The Federal Reserve's targets for money growth are so restrictive that, given the expected rate of inflation, rapid real growth is unlikely.

There is considerable risk, however, that real growth will be even weaker than that forecast by CBO. Indeed, if interest rates do not moderate, or if they rise, during the downturn the recovery could be delayed. This is not the CBO forecast, but the possibility of such an outcome cannot be ruled out.

Question: In a recent article, Fortune Magazine proposed an alternative method of borrowing funds that could save $28 billion on Fiscal 1984 interest expenses. They propose to issue inflation-adjusted Treasury notes that pay a small real interest rate instead of the present high-fixed-rate securities.

What are your feelings about the feasibility of this proposal?

Answer: Under the proposal contained in a recent article in Fortune ("How to Cut Those Deficits--And Why," February 22, 1982), the government would issue large amounts of ten-year "inflation-adjusted notes." The interest payments on these notes would consist of two parts: a real rate of interest and an inflation adjustment based on some form of inflation index. (An alternative approach would be to index the principal rather than interest payments, which would defer more of the government outlays until the bonds mature.) The budget savings realized would depend on the number of bonds issued by the Treasury and the yield differential between these "inflation-adjusted notes" and the notes and bonds that would otherwise have been issued. Because of the built-in protection against inflation, the inflation-risk premia that are present in current market rates would be eliminated; the larger the inflation-risk premia, the greater the budget savings. Moreover, to the extent that capital markets are currently overestimating the momentum of inflation, the prospective budget savings could be larger still. Very little is known about the size of this kind of risk premium, and it is extremely difficult to predict inflation accurately. In addition, the article suggests that a small real rate of interest of perhaps as little as one percent might be sufficient to induce wealth holders to purchase these notes; but the necessary real rate of interest could turn out to be considerably larger, particularly if a large amount of such notes were issued.

Although this proposal might reduce current budget outlays, it would not be a "free lunch." The government (that is, taxpayers) would be assuming the risk that is currently taken on by holders of government bonds; namely, the risk that inflation might be higher than expected. Thus taxpayers would be providing bondholders with insurance that in the event of more rapid inflation--due to energy and food price shocks, for example--they would not suffer a real loss.

Another potential drawback to the proposal is that the insurance of large amounts of inflation-adjusted notes of ten-year maturity could affect the term-structure of interest rates in a way that raises the cost of private sector borrowing for capital investment. In addition, if policymakers believe that inflation will come down rapidly, they could simply direct that most new debt be issued short-term, without resorting to the issuance of indexed notes of ten-year maturity. Finally, as with any indexing plan, there would be a number of technical issues, such as which inflation index to use and how to treat the inflation adjustment for tax purposes. In this country, various forms of government bond indexing were widely discussed among economists during the early and mid-1970s, including proposals by such leading economists as Professor James Tobin (1971) and Professor Milton Friedman (1974). In addition, some form of government-backed indexed bonds have been adopted by several countries, including Argentina, Brazil, Colombia, and Chile in South America; and Israel and the United Kingdom in Europe. In the United Kingdom, however, the program is quite limited in scope, and viewed primarily as a way of providing security to pensioners. Inflation-adjusted bonds have also been viewed as a way of encouraging saving during inflationary times, or as a step toward indexing the income tax system.

In sum, while government-backed, inflation-adjusted bonds have been proposed for a variety of reasons (and used in some countries), the efficacy of this kind of approach is uncertain as a means of significantly reducing the budget deficit, and it could have serious repercussions, particularly for private capital markets under current weakened circumstances.

## SUBCOMMITTEE RECESS

Chairman HATFIELD. The next meeting will be March 4, at 9:30 in this room, when Mr. Volcker and Dr. Kelso will give testimony.

We stand in recess.

[Whereupon, at 12:05 p.m., Thursday, February 25, the committee was recessed, to reconvene at 9:30 a.m., Thursday, March 4.]

# ECONOMIC OVERVIEW FOR FISCAL YEAR 1983

THURSDAY, MARCH 4, 1982

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
*Washington, D.C.*

The committee met at 9:39 a.m., in room 1114, Everett McKinley Dirksen Senate Office Building, Hon. Mark O. Hatfield (chairman) presiding.

Present: Senators Hatfield, Weicker, Schmitt, Stennis, Eagleton, and DeConcini.

## FEDERAL RESERVE SYSTEM

### BOARD OF GOVERNORS

### STATEMENT OF PAUL A. VOLCKER, CHAIRMAN

#### OPENING STATEMENT OF SENATOR SCHMITT

Senator SCHMITT [presiding]. The Committee will come to order. Chairman Hatfield will be in in a short period of time. He was detained in the Rules Committee.

Today the committee will resume its economic overview hearings with a focus on monetary policy. Our witness today is the indefatigable Paul Volcker, Chairman of the Board of Governors of of the Federal Reserve System. Following Mr. Volcker, we will hear from Louis Kelso and Patricia Hetter who will explain their concept of "social capitalism" to the committee.

Chairman Volcker, it is a pleasure to have you back before the committee. You contributed immensely to our overview hearings last year and I understand that you had to do considerable juggling of your schedule to appear today and we appreciate it.

The role of monetary policy, as a result of the discussions and to some degree controversy that you and others have generated, is gradually being appreciated, increasingly by the American public. The persuasive evidence that we have, that cycles in the rate of growth of monetary policy correlate on a delayed basis of about 24 months with cycles in the inflation rate is fairly well accepted among most of the economic community and it is certainly accepted by this Senator.

Your efforts to control that growth of money supply at lower limits of your targets is, I think, the correct policy and I commend it to you in the future.

We will be happy to receive your statement, and I am sure the members of our committee will have questions for you. Those questions, together with your response will be inserted in the record at the conclusion of your testimony.

Mr. VOLCKER. Thank you, Mr. Chairman.

Senator SCHMITT. Excuse me, Mr. Chairman. Senator Stennis and Senator Eagleton, do you have any statements?

Senator STENNIS. Thank you very much, Mr. Chairman. It suits me fine to proceed.

Senator EAGLETON. Please proceed.

### INTERACTIONS BETWEEN MONETARY AND FISCAL POLICY

Mr. VOLCKER. I have a statement, Senator, that is very similar to other statements I have delivered recently. I don't know whether there is any purpose to be served in my reading the whole statement. I thought I might read the latter part of it, on monetary policy and fiscal policy and the interactions between the two, particularly as related to the interest rate problem that is so preoccupying all of us.

The first part of my statement reviews the current economic situation, the fact that we are in a very difficult recession, and suggests why the probability is that we can expect some recovery later this year. It is extremely important that we get policies in place if we are going to permit that recovery to continue—not just to start but to continue—and be sustained. I review the monetary policy developments over the past year or so very briefly, and point out that in general we have been bringing down the increases in money supply, as you mentioned.

### INTEREST RATE LEVEL

We are left with this unusual situation in the middle of a recession of interest rates having risen and the money supply having risen some. In the past few years that somewhat reversed itself, but no doubt interest rates are extraordinarily high, and at the present time—I am picking up in the middle of page 5—those interest rates have remained high despite visible progress—and potentially lasting progress—on inflation. To be sure, some of the progress against inflation reflects the more immediate, and potentially reversible, effects of recession-weakened markets, current surpluses in petroleum and grain production, and reduced commodity speculation and pressures generally for inventory liquidation due to extraordinarily high interest rates. However, we can now also see encouraging signs of more lasting progress. Attitudes of business and labor toward pricing and wage bargaining, and toward work rules that hamper productivity, seem to be changing. Not surprisingly, that is most clearly apparent in industries where costs and wages have been most clearly out of line and where international competitive pressures or those resulting from regulatory change are particularly intense. But, so long as monetary and fiscal policies are appropriate, I believe these changes will be reflected in a spreading pattern of cost and price restraint. Individually, workers and businessmen are naturally reluctant to maintain such restraint, partly for fear their concessions will not be matched by those of others. But collectively, such restraint, combined with higher productivity, will be amply repaid in the form of higher real wages and better prospects for job security.

### RESTRAINTS ON MONEY EXPANSION

If these brighter prospects are to be achieved, however, we cannot afford—just as the disinflationary process is beginning to take hold—to abandon our monetary vigilance. Past failures to "carry through" have left a legacy of skepticism and uncertainty among workers and businessmen, among consumers, and, not least, among participants in financial markets where lenders demand "inflation" and "uncertainty" premiums when committing their funds. That is one important factor holding up longer-term interest rates. Credibility in dealing with inflation will have to be earned by performance and persistence over time. And, I believe, it is broadly and rightly recognized that appropriate restraint on the expansion of money and credit will continue to be fundamental to restoring price stability.

### MONETARY TARGETS

In the next paragraph or two I review, in very general terms, monetary targets for this current year that we announced a few weeks ago, making the point that we do think those targets are consistent with recovery but that they are also aimed at continuing to encourage progress toward price stability. They are designed, not terribly liberally, but to be a tight fit in those circumstances.

### CREDIT MARKET PERFORMANCE

The performance of the credit markets in 1982 and beyond, in a framework of disciplined monetary policy, will be heavily influenced by supply and demand forces other than the course of inflation and inflationary expectations. Key among these is the size of the Federal deficit.

Government borrowing and private borrowing compete for a limited supply of available savings and credit. That competition is usually ameliorated in the midst of recession because private credit demands are reduced. But a more prosperous economy also implies that much stronger needs for mortgage and business credit; indeed, sustained recovery of the private economy, and the investment we need to support productivity, is dependent on more favorable financial market conditions. It is precisely those more favorable market conditions that are threatened by prospects for sharply rising deficits in fiscal 1983 and the years beyond.

### SIZE OF FUTURE DEFICITS

You have had a lot of testimony about the potential size of those deficits if nothing is done and assuming the administration's defense program. There really isn't any dispute about the general proposition that, even with the economy expanding steadily in the next few years, those deficits are going to reach historically very large numbers of $150 billion and will be rising thereafter. Everybody's projections agree on that.

I think some implications of that are very clear. In the absence of action, the projected deficits would be outside of the range during peacetime for good business years. That is true with it whether you measure in dollars, whether you measure in relation to GNP or to full employment GNP or our savings potential.

### ADMINISTRATION PROPOSAL FOR SPENDING CUTS

The Administration certainly shares those concerns and has proposed large cuts in spending and some measures to increase revenues. If you take a package of the size the administration has proposed, I think that we will go a long way toward bringing the deficits down; it will cut them by one-half or so by fiscal 1984. But I emphasize that, even with that kind of action, the size of the projected deficits would remain large, relative to savings and the GNP, for a relatively prosperous business year. While a few years in the 1970's appear roughly comparable, there would appear to be little or no "safety margin" for meeting expanded investment requirements. Should the deficit trends be more adverse, as the Congressional Budget Office suggests, the potential for "crowding out" private investment would be greater.

I think that possibility of a less favorable outlook than the administration has projected does need to be taken seriously in your deliberations. This is not the time for over-exuberance in estimates, given the dangers that exist.

### INCREASE IN SAVINGS

A substantial increase in savings could help protect against the implied squeeze on financial markets. Indeed, business saving is likely to be enhanced substantially by the provisions of last year's tax bill, and personal saving should also be increased as inflation declines and in response to other incentives. But we also need to remember that the larger savings potential should not be dissipated in financing Government purchases or transfer payments when our investment needs are so urgent.

The hard fact is we cannot escape a choice: do we want to encourage more favorable financing conditions for the private sector, or are we willing to risk seeing our savings and financial resources diverted in large measure to financing a Federal deficit.

### FUTURE PLANNING NEEDED TO DEAL WITH DEFICITS

Let me emphasize, too, while it is the deficits for fiscal 1983, and particularly 1984 and beyond, that loom so large in my mind, action is needed now for several reasons. First, as you know better than anybody else, the budgetary momentum cannot be curbed without planning ahead. You have to take action now if you are going to deal with 1983 and 1984, which is where the problem lies.

Second, we are in a situation now, more so than any time in our history, where the big deficits in the short run add to the deficits in a slightly longer run, because those deficits have to be financed.

### FUTURE CREDIT MARKET PRESSURES

Finally, what I would emphasize in terms of our immediate problem is that uncertainties about future credit market pressures cloud the planning of investors today. Strong actions taken now to assure that deficits can and will be reduced as the economy recovers can go far toward galvanizing investor attitudes in a favorable direction. Paradoxical as it may seem in the light of some past economic analysis—analysis developed when inflation and high interest rates were not a preoccupation—prospects for recovery can be speeded by decisive action by this committee and your congressional colleagues to curb future deficits, for the result would be to relieve apprehension in the market that contributes to today's high rates.

### REDUCTION OF DEFICITS

I review the administration's proposal quantitatively in my statement, but I would urge upon you the desirability of going even further to reduce, demonstrably, the pattern of deficits as the economy recovers. I would hope you have a target of restoring budgetary balance at a suitably high level of activity.

In approaching that problem—and looking at purely economic criteria—I believe that doing that in the context of this low tax rate is better than doing so at higher marginal tax rates that distort incentives and impede economic efficiency. You have a lot of other considerations to take into account—security considerations—social objectives, and I would say, to the extent the job cannot be accomplished by the first steps of reducing spending growth, then I think you have to look at the revenue side of the budget and take action there. This seems to me consistent with the broad direction of economic policy set out a year ago, which seemed to me appropriate both in the monetary and fiscal area.

We are making progress against inflation. I think that is fundamental to our future, but we do have to take further steps to deal with this problem. I think the Federal Reserve is going to have to maintain the needed degree of monetary discipline, and I am encouraged by the extent to which I believe this budget problem and the problem it presents for monetary policy is recognized.

It seems to me there is a lot of intellectual consensus on that point, a lot of appropriate concern in the Congress. Of course, the challenge is to covert that concern into action.

Chairman HATFIELD [presiding]. Thank you, Mr. Volcker. I apologize for being late; I was in the Rules Committee meeting and I couldn't get over here.

### RECOMMENDATIONS FOR BUDGET REDUCTIONS

Mr. Volcker, in your many calls to decrease the expected budget deficits in 1983 and beyond, have you attempted at any time or in any way to target particular areas for reductions which would give us the basis for the most beneficial effects of the economy?

Mr. VOLCKER. I really have not in any way that is particularly useful to your committee. You have to make these very difficult, precise decisions.

I can make a general comment that, to the extent you can do it on the spending side—I am talking in economic terms—that is more desirable. Obviously, the more you reduce spending programs that adversely affect incentives in the economy, the better off we will be. I am as familiar with the arithmetic as you are, if you are going to have a large reduction on the spending side, it is going to be a pretty broad-based attack. You can't afford to exempt very large portions of civilian expenditures, for instance, whatever one thinks about the defense side.

### INTEREST RATE DECLINE

Chairman HATFIELD. Do you believe that the recent drop in the prime rate and the Treasury bill interest rates signal the beginning of a downward trend of interest rates?

Mr. VOLCKER. I would certainly hope so.

Let me say that we had a volatility in interest rates. Nobody can project them very well in the short run. But in the long run perspective, these interest rates are certainly extraordinarily high, given the fact that we are in recession but, more importantly, relative to what I think is a reasonable appraisal of the current level of inflation and the direction that inflation is going. If one is willing to make an assumption—as I would, but maybe the market isn't ready to yet—that we are turning the corner on inflation, these interest rates over time have no place to go but down, in my opinion.

The budgetary prospect affects that for two reasons. It affects the credibility of any statement that the inflation rate is going to come down. Psychologically, in most people's minds, large budget deficits, at least of this magnitude, raise great questions about the inflationary outlook.

Regardless of that, doing that much Government financing puts pressure on interest rates and leaves them higher than they would otherwise be. That is a factor in this equation.

### REASONS FOR CURRENT DROP IN INTEREST RATES

Chairman HATFIELD. Let me go back, then, to the experience—let's go back to mid December or a little bit earlier. We had some comments recently by Dr. Weidenbaum and Secretary Regan that they thought the large erratic growth of the money supply late last year was the sole reason for the rise in interest rates since mid December.

What do you believe caused that surge in rates and what caused the more recent decline in interest rates? Could the drop in money announced Friday, February 19, be responsible for the decline?

Mr. VOLCKER. One influence on the money markets in the short run is certainly what the demand for money is. When the money supply went up—which was rather unusual in terms of the size of the increase, when production was declining, economic activity was declining—that created an anticipation that, consistent with our own announced intentions, pressure on the money market would develop as a byproduct of the money supply moving back toward our objectives.

The market sees the change in the money supply; it is likely to react in the expectation that might happen; and, indeed, there was greater pressure on the banking system in January or February than in November and December because of the increased money supply.

That was certainly a factor in the increase of interest rates during that period.

Also, this was the period when budgetary figures were announced; the market was not terribly optimistic, I think, about what they might show. And the official confirmation of the degree of the budgetary deficits was also in the background here. I think that is particularly important in terms of the longer-term markets. The longer you go in the maturity spectrum, the more rates are affected by expectation—not by what is happening in the money market today but what might happen next year, the following year, or thereafter, because these people are making a commitment for a period of years.

Yes; the short-term influence of the money supply changes the market reactions, but interest rate rises come in the context of this continuing concern over the longer range future.

### TURNING OF CORNER IN INFLATION

Chairman HATFIELD. Mr. Volcker, could I summarize the good and bad news in context? Do you feel that we have seen a turning of the corner, perhaps, on inflation?

Mr. VOLCKER. Yes.

Chairman HATFIELD. With regard to interest rates, we have now some pretty good signals on at least short-term decline in the prime rate and Treasury notes.

Mr. VOLCKER. Yes.

Chairman HATFIELD. But then if we were to look at the other side, I suppose the caveat to the good news might be the bad news which is, as you see it, projected Federal deficits——

Mr. VOLCKER. Yes; that is one major element. Even your good news in the short run is a decrease from an extraordinarily high level, so you are still left with a very high level of interest rates given both the inflation rate and the economic position.

Chairman HATFIELD. Were you thinking that the downward trend in interest rates might continue?

Mr. VOLCKER. Yes.

### FUTURE DIRECTION OF INTEREST RATES

Chairman HATFIELD. What are the prospective long-term interest rates when we talk about the decline of interest rates? Assuming we commit this Nation to greater control of the budget and smaller deficits through some agreement with the President, where do you see interest rates moving, to what level?

Mr. VOLCKER. When you ask for a projection in the short run, I can't quantify that. I am convinced that if there were a program that the people considered credible—not just some published numbers or a resolution, because people will look to see what is behind that resolution and see whether the actions line up to the statement—I think you would have an improvement, a marked improvement in atmosphere, if people were really convinced that the administration's budgetary projections after action were fully credible. But what they have in front of them now is, let's say, a report of the Congressional Budget Office or their own reports saying, "If you go with the President's program you are going to be left with a deficit of $120 billion next year and rising."

If they were really convinced it was going below $100 billion and falling, I think you would get an improved atmosphere. If you went beyond that, which I think the situation calls for, and you are credible, while I can't measure the reaction in precise percentage points, I think you would have a dramatic change of atmosphere in the markets.

Chairman HATFIELD. Nine percent? Ten percent range?

Mr. VOLCKER. If you look at Government bond rates now, prime long-term rate is between 13¼ and 13½, and it has been stuck up in that area or higher for a long period of time. That is the real acid test: are people willing to buy a 30-year bond on the basis of a 2-year action? Are they going to feel better and buy them with more aggressiveness, particularly if we get that change in budget on top of the other favorable news on inflation? But precisely where that will go in the short run is too hard to predict.

### DOWNWARD TREND OF DEFICIT

Chairman HATFIELD. Aren't you saying, in effect, there has to be a perception in which the Federal Government has control of the fiscal household? Is it not so much the level of the deficit in the quantitative sense, but rather in the sense we have control of it? Is it going downward, not continuing in an out-of-control escalation?

Mr. VOLCKER. I think that is a large element. You can't ignore the level. But, and I am sure this has been said over and over again, I would just emphasize that what is unique in my experience and in anybody's experience about this budgetary situation is that, really, for the first time—whatever difficulties people may have with the precise figures—if you make the simple assumption that the economy is going to grow year after year by some reasonable amount, you get bigger deficits every year. In the past, whenever you made the assumption that the economy was going to grow 3½ or 4 or 5 percent a year, you would generate a budget surplus, and you would begin talking about what programs can we add or what taxes can we reduce. Now, for the first time, with the programs in place, you get this inexorable increase in deficits, and that is what has to be changed.

Chairman HATFIELD. Senator Stennis.

### PREPARED STATEMENT

Senator STENNIS. Thank you, Mr. Chairman. I have a brief statement here. To save time, I ask that it be included in the record at this point.

Chairman HATFIELD. It will be included in the record.

[The statement follows:]

## STATEMENT OF HON. JOHN C. STENNIS

Mr. Chairman, I want first to express my appreciation to Mr. Volcker for appearing before your committee and giving us this opportunity to share in his thoughts concerning these troubled times. I want to offer my special appreciation for his leadership and steadfastness in resolving our national economic problems. The field of economics is not my specialty, but I am aware that the relationships between the Government's fiscal policies, the Federal Reserve's monetary policies, and our economy are very complex and require the knowledge and counsel of men with his experience.

I have recently toured my State, visiting 77 of 82 counties within the first month or two, stopping by courthouses, newspaper offices, town squares, talking to bankers, businessmen, and workingmen. I am impressed that the people singlemindedly believe that our economy is in serious trouble and at the root of that trouble are high interest rates. They see high interest rates as the reason for businesses going broke, manufacturing plants closing or being put on a short workweek, and they are expecting something to be done to bring an end to this and restore our economy to its full health. I don't believe there is any special institution or person that can be blamed for these high interest rates, but I believe that we have reached a point at which the people expect someone to offer a positive plan for reducing interest rates and restoring prosperity.

I remember last year, in January, at these very hearings on the economy we were given assurances that if we enacted the President's program interest rates would fall. And they did to a degree, but now it seems that again we face a very gloomy outlook, and there are abundant forecasts that interest rates may reach higher levels during the year. It is my hope today that you will discuss from your experience and your perspective what can be done to restore our economy to its full capacity and bring an end to this recession with its high unemployment and low productivity. Specifically, I would appreciate hearing your thoughts on what actions could be taken by the Federal Reserve, or the Congress, or the people, to bring about lower interest rates.

### INCREASE IN GOVERNMENT SIZE

Senator STENNIS. Mr. Volcker, I think it is a tribute to you and the President of the United States, elected in the political process and you by appointment, even in another administration, you work together in a large degree and there is more power vested in you two than any other two people in the Government or any other department of the Government.

I am confident that both of you are doing your very best. I remember when the act was created under which you are operating, the idea of being independent, and we have clung to that all these years.

Do you have any figures that compares the size of Government now and what it was when this act was passed in 1913?

Mr. VOLCKER. I don't have any figures with me. But as you know, Senator, it would be a very large multiple of what it was then, however you measure it.

Senator STENNIS. Isn't it amazing the system is working, the Government magnified in size and problems, have become a world power in both wars, the Depression, the era of production, and still this act holds on without a great deal of amendments. I think it is one of the big things our Government largely overlooks.

Mr. VOLCKER. I think it serves us pretty well.

If I may interject a comment, Senator. Let me point out that while I preside over the meetings and I give most of the congressional testimony, the Federal Reserve is made up of a Board of Governors and a number of regional banks. I mention this because I think there has been remarkable unanimity among this group of people, appointed under different circumstances, from a variety of backgrounds, over a long period of time.

Senator STENNIS. That is encouraging. I remember Woodrow Wilson saying at the time he was going to move the money capitol of the Nation from Wall Street to Pennsylvania Avenue. And that sentiment is what put it over has worked so well. I am proud of it.

### INTEREST RATES

But we are up against a different situation, it seems to me, this time because as I understood it ordinarily you have gotten good results in holding interest rates down or bringing them down to stay at a stable level, but it is not working this time in the ordinary fashion. Isn't that correct?

Mr. VOLCKER. We are doing it a little bit differently this time.

Senator STENNIS. You answer the question and explain. The people need to have as direct an explanation of this situation as you can give them, I think. It is amazing how they caught on and have gotten into the feel and understanding of this complex problem.

Mr. VOLCKER. I think there is much better understanding now of the very broad relationship between growth of money and credit and the inflationary problem, and recognition that we have to deal with excessive growth of money and credit. When one raises the question of why interest rates are so high now relative to earlier periods—particularly earlier periods of recession, but even before we were in the recession—I think what is really unique about this situation is that never before in the history of our country have we had inflation over such a prolonged period; that has gotten into people's minds, it has gotten into their anticipations, and it has gotten into their behavior in a way it never has before.

One reflection of that is that during 15 years of inflation, bonds didn't turn out to be a good buy, during a large part of that period the actual interest return on them was negative. People became very cautious about making a bet on inflation going down, they became cautious about making a bet on interest rates coming down, and we are now suffering from that expectation which built up over a period of years. That is why it is so difficult to turn it around.

### CREDIT SYSTEM VICTIMS

Senator STENNIS. Well, a bond buyer is entitled to sympathy. But I am thinking about these people that do business on credit. It is a credit era and they just can't get around it, they can't buy a car to go to work, they can't buy a little home, a modest home, start one, anything, interest rates are intolerable, they can't pay it. We are grinding down to a gradual halt down our way and, frankly, have no substitute for it. We are not notorious spenders, we are kind of chintzy with our money, but we are about at the end of the road. I am not crying poor mouth. I am trying to describe the economic wheels are not turning and the people are victims of it, the credit system. We are victims of the credit system to start with. I know you are trying, but you say yourself you are disappointed in the lack of volume of response.

Mr. VOLCKER. We beg for some help, and you are in a position to give us some help. At the same time, the greater part of this picture is that inflation is responding. That is very fundamental. People may not yet fully believe it, but I think they are coming to believe it as every month passes, and that is of fundamental importance.

Senator STENNIS. From the inflation decrease?

Mr. VOLCKER. Yes.

### EFFECT OF INFLATION ON INTEREST RATES

Senator STENNIS. You think that is a basic change that is going to be reflected in the interest rates in time?

Mr. VOLCKER. Yes, sir.

Senator STENNIS. Provided there is reasonable action by the Congress and the economy spending?

Mr. VOLCKER. Yes, sir.

Senator STENNIS. Let me put it this way, Mr. Chairman, I am not looking for a pat on the back to what we did last year, Congress, but suppose we had not improved the situation, suppose we had not reduced spending any and firmed up on things to the extent we did, where would we be now?

Mr. VOLCKER. Worse off?

Senator STENNIS. Worse off.

Mr. VOLCKER. We would have higher interest rates.

Senator STENNIS. I ask you to speculate on that a little more definitely than you did.

Mr. VOLCKER. Let me point out that Congress last year also passed a big tax reduction. It is the combination of the tax reduction, the higher defense spending, and some cuts in civilian spending which by past standards were very large but were not as large as the tax reductions by a tremendous margin nor as large as the increase in defense spending. The tax cutting/defense increasing side outpaced what you were able to do on the civilian spending side. If you had not done that you would still be worse off. But you left yourself a legacy, if I may say so, of a considerable need for further action to bring those two lines into balance.

Senator STENNIS. To give it the real meaning, then, it would take further action?

Mr. VOLCKER. That is right.

### OVER-ESCALATION OF ENTITLEMENT PROGRAMS

Senator STENNIS. Here is our congressional nightmare, I call it, the indexed payments, the entitlements, the vested right to the money payments, automatic increase, entitlements—I never did see how that term exactly described it, but it does, the automatic increase is what I call it. Until we get into that and make some kind of adjustments, we will have this continued problem even if we get out of this situation we are in now, will we not?

Mr. VOLCKER. It is hard for me to see how you can adequately attack the budgetary problem without getting into that area.

As you know, Senator, there is, in fact, considerable evidence that many of those programs that are automatically escalated are "over-escalated" in a sense in terms of the real change in inflation and the cost of living over the years. When you have that built in during a period of declining inflation—particularly when the indexes tend to look backward instead of forward—you don't have too good an index. That will aggravate the budgetary problem, there is no question about it.

Senator STENNIS. Mr. Chairman, I thank you for the time. I have two questions, may I submit those for the record?

Chairman HATFIELD. Certainly.

Senator Eagleton.

Senator EAGLETON. Thank you very much, Mr. Chairman.

At the outset, with regard to Senator Stennis's statement that Congress might pat itself on the back for what it did last year, I think history will say that Congress should hang its head in shame. The revenue bill of 1981 in no small measure contributes to our current dilemma.

### WAYS OF REDUCING DEFICIT

Let me ask this question, Mr. Chairman. To make a realistic impact on these colossal deficits that you have discussed, isn't it going to take a combination of things such as entitlement reduction, some cuts in the defense portion of the budget, and a significant recapture of some of the revenues given away in the 1981 bill?

Mr. VOLCKER. I think it certainly is going to take a very broad-based attack. Although it is your business not mine, it is very difficult to see how you are going to do it on the spending side alone. The President, of course, has proposed some revenue measures. That does not mean, in terms of clarification, that I think it is necessary, for instance, to change what I think of as the core of last year's tax bill, the reduction in individual tax rates or the accelerated depreciation for corporations; there are other ways you can go about raising revenues.

Senator EAGLETON. Do you rule the 1983 personal tax cuts off limit, the final 10 percent?

Mr. VOLCKER. I don't know whether I would rule it off limits. But, let me say, I think there are better ways of going about it. I think, certainly, there is a real economic rationale for that. My own feeling is for maintaining that component because, in general terms—not just looking at the current budgetary problem, but looking at the structural problem over a period of time—I, myself, believe that from an economic standpoint we in this country have come to rely too much on direct taxation, which evidently leads to marginal tax rates that are pretty high and does affect incentives in various directions and creates distortions. I am inclined to think that, as a matter of tax structure, we would be better off shifting to some degree—we are talking about a matter of degree—into other kinds of taxation. I would raise questions now in terms of all our economic problems, and given our energy problem and the problems of energy dependence, I would ask whether some kinds of taxes in that area may not help to support the conservation effort and, indeed, to support domestic incentives for energy development.

There are places you can look for change other than at the basic tax rate schedule. There are a whole series of loophole questions, tax expenditures. I think there are quite a few places to look.

### VALUE ADDED TAX

Senator EAGLETON. I agree. Are you at all smitten with Lester Thurow's "Value Added Tax?" He is one of our witnesses tomorrow.

Mr. VOLCKER. That fits into the general comment I made about the type of taxation. I am not smitten with that idea as a solution for your current budgetary problem, because it is too basic a change to introduce, it seems to me, in the short run, in all probability. I am not at all opposed to that as a longer term, structural measure, but it is hard for me to see that as the answer to your immediate problem.

### OPERATING DEFINITION OF DEPRESSION

Senator EAGLETON. My final question is this, Mr. Chairman. I will read you a few brief quotations and ask a question: Alan Greenspan, "The chance that a sharp new downturn could reach crisis proportion used to be 1 in 100, now it is 1 in 5 or 10.". Allen Sinai, "If interest rates rise again, industries such as housing, automobiles, and airlines would not have recovered sufficiently. The third recession in 3 years would probably be strike three." Edward Yardeni, chief economist, E. F. Hutton, "I don't want to start a panic or alarm people, but I think there is a 30-percent chance of a depression occurring. This is a very atypical recession, financial pressures are growing and Washington policymakers are amazingly complacent with the problem." James McKevitt of the National Federation of Independent Businesses, "It has never been so bad. Small businesses are dropping like flies." Paul Craig Roberts, recently of the Reagan administration, "If the Government now responds to the budget deficits with more of the policies that produced them, it might push the economy from recession into depression."

My question is, what is your operating definition of a "depression"? Are we headed in that direction? And how close are we to it?

Mr. VOLCKER. I don't know what my operating definition is. Those are colorful terms, but they don't have much economic precision to them.

I think you can see forces in the economy that should produce a recovery. One of those people you quoted said this is not a "normal recession." It has some characteristics of a normal recession and some characteristics that are abnormal, including the current interest rate picture. I think the probability of something you or I would think of as a depression is very small. We have support in the economy of the kind we didn't have in 1913, as the Senator pointed out, the role of Government is very different now. It is maybe to the bad, but one of the good things about Government taking 20 some percent of the GNP, running these kinds of deficits, is that that makes it hard to have the kind of depression of, let's say, the 1930's. There is a lot of support for the economy right now, and I am not worried about the current deficit from that prospective tax cut in July. We have production, I think, rather generally running below consumption. Theoretically consumption can go down, but I think more likely production is going to go up and that puts some momentum into the economy.

If you ask me whether there are risks to a recovery scenario, I think the answer to that is yes, and a lot of them revolve around the financial market. We could get caught in a recession, no improvement. That kind of risk I certainly can see. I think the recovery scenario is the probable one, but you obviously want to minimize those other risks since so many of those risks revolve around interest rate in the financial market. I think we come back, in considerable part, to this budgetary problem. Again, I am not talking about the deficit today; nobody is talking about raising taxes in 1982 and nobody is talking about tremendous expenditure reductions in 1982. The problem becomes more acute as you look out there in 1984 and 1985, with 1983 as the transitional year. To deal with these future problems you are going to have to begin action now, and there is no greater contribution you can make to minimizing the risk and maximizing the favorable outcome than dealing with that future budgetary problem. That is where all my emphasis is.

### FINANCIAL MARKETS

Senator EAGLETON. Could I ask one more question because you mentioned financial markets? How significant is the problem of the savings and loan industry and depending on your definition of the illness, what should be done to cure it?

Mr. VOLCKER. It is in a very difficult situation. They got caught with a load of old assets purchased 10 years ago, have yields much lower than current interest rates. The only satisfactory solution to that problem is seeing interest rates come down, but they face, in the best of circumstances, an extremely difficult transition period. There are going to have to be more mergers of the kind we have seen so far. I certainly think the existing apparatus is adequate to deal with the situation at present and affords the appropriate backup to the commitment that those deposits are safe. As to whether more needs to be done, we have urged for months now—and it is not a fundamental solution, but it is not only desirable but really necessary—that the regulators have more flexibility in dealing with this merger problem, more flexibility in injecting capital into some of these institutions.

We have had a bill before Congress—it passed the House—that provides more flexibility in those areas. I would hope that passes both Houses. Whether anything significant needs to be done beyond that remains to be seen. It is a serious problem. I would not minimize it.

Chairman HATFIELD. Senator DeConcini.

Senator DECONCINI. Thank you, Mr. Chairman.

## FINANCIAL CRISIS RESULTING FROM HIGH INTEREST RATES

Chairman Volcker, yesterday in the Washington Post we saw an open letter from the president of the National Association of Realtors and national chairman of the Association of Mutual Savings Bank, president of the National Association of Home Builders and the American Bankers Association. I would like to read to you just a little bit of that and ask for your response.

It starts off with a statement about prolonged high interest rates are economically a financial crisis in this country. In order to bring interest rates down immediate action must be taken to reduce massive Federal budget deficits. More than anything else, it is the specter of an overwhelming volume of deficit financing which haunts housing and financial markets imposes a threat of economic and financial conditions not seen since the 1930's. Given these circumstances, there is no alternative but one, slow down all spending not excluding defense and entitlement programs and two, if necessary, referring to the previous enacted tax reduction for increased taxes. In order to have the necessary impact on financial markets, these actions should be taken prior to any increase in the ceiling on the Federal debt.

Can I have your response to the first paragraph as to the severity, and two do you agree or disagree that before we raise the national debt ceiling that we should do these two things that are recommended here?

Mr. VOLCKER. On the first point, it is somewhat more colorful language, perhaps, than I would use, and I don't see a depression out there, as we just discussed. But I see the sense of urgency conveyed in that statement about the budgetary problem; I could have written it myself, I suppose.

Taking it into the debt ceiling, you are going to have to increase the debt ceiling or the Government is not going to be able to operate. It is a question, I suppose, of legislative tactics, how these things are tied in, but that kind of time period that is implied in their statement seems to be what the doctor ordered.

Senator DECONCINI. In other words, we ought to do something prior to the date that we may have to vote to raise the debt ceiling?

Mr. VOLCKER. I think we clearly have the problem right now in the markets. We have all this uncertainty about the economy, we have the kind of questions and contingencies I referred to earlier, not drastic in my judgment, but very real in terms of the sense and timing of recovery. But I think the time to act is now.

## DEFICIT FINANCING

Senator DECONCINI. Do you agree with the statement that the biggest problem haunting these industries is the overwhelming volume of deficit financing?

Mr. VOLCKER. I think the biggest problem is financial markets and, in turn, that gets you right into this deficit problem. Again, I put the emphasis on future years not on this year.

### OFF BUDGET CREDIT PROGRAMS

Senator DECONCINI. The total funds raised in the U.S. credit markets under all Federal programs, but budget and off budget is scheduled to increase from $142 billion in 1981 to $260 billion in 1982 and increase 45 percent. Assuming the supply of credit grows, that only is the average rate of increase for the last 10 years, this means that the Federal program will preempt over 45 percent of all available credit, the highest percentage in the last 10 years.

What effect are these off budget credit programs going to have on interest rates in your judgment?

Mr. VOLCKER. They tend to squeeze out other forms of credit borrowings that are not guaranteed and supported by the Government. I don't have your figures in front of me. You are including guaranteed programs and indirect Government credit programs. Depending on what you do and do not include, the figures may be larger or smaller, but they show the same pattern. It is inherent in the budgetary picture that the preemption of the Government in the credit markets would be extraordinarily large by historic standards.

That is certainly true if you don't adopt a program at least as big as the President's program. If you take the President's program, you are left in a high historical range; if you get less than what he is proposing, you are left without any historical precedent for a good business year, and that does imply a squeeze in financial markets.

### ADMINISTRATION-PROJECTED DEFICIT

Senator DECONCINI. The administration estimates at least a deficit of $91 billion. In your best judgment, is that unsatisfactory for this Congress to proceed with?

Mr. VOLCKER. I think all the risks make me urge upon you that you go beyond that.

Senator DECONCINI. To go further.

Mr. VOLCKER. Ninety-one billion dollars is not in itself a level that I can say necessarily is inconsistent with recovery. I would urge upon you the desirability of a large safety margin. You have to look at analysis, for instance, of the Congressional Budget Office that says even with his program you are not going to hit $91 billion because of technical factors. Those estimates are always difficult. How much of a margin do you want to give yourself? I would strongly recommend——

### MONEY GROWTH RATE

Senator DECONCINI. Can you give me a short synopsis of the rate of the money growth supply last year what it was the year before that in 1980 and what you think it will be this year?

Mr. VOLCKER. If you look at it on an annual average basis, which reflects everything that has happened during the year, you will find that the narrow aggregate, M-1, has declined at a rate of a little more than 1 percent a year for the last 3 years, including last year.

Senator DECONCINI. What was it in 1980?

Mr. VOLCKER. We have some figures here that only have fourth quarter to fourth quarter, I can give you those. But these do not reflect the annual averages.

Senator DECONCINI. Can you supply that?

Mr. VOLCKER. I have it here. It was 4.7 percent last year.

Senator DECONCINI. That is for 1981?

Mr. VOLCKER. For 1981. It would have been 5.9 percent in 1980, 7.7 percent the year before, on average.

M-2, which is a broader aggregate, has been about even during these years. It has not changed. It has been in about the 8½ to 9½ percent area each of those years. It was actually a little higher last year—about 9¾ percent—than in earlier years.

Senator DECONCINI. What do you project it will be for 1982?

Mr. VOLCKER. For 1982, if you look at an average, it depends upon where we come out within our target. The committee said as things now stand we would find something in the upper part of our target range acceptable. I think you will find M-1 on the average about the same as last year, or maybe a little higher. I am comparing an M-1 figure this year with what we called M-1 adjusted last year, adjusted for institutional change. M-2 we would expect to be a little lower this year than last year.

Senator DECONCINI. So we can estimate on an annualized basis a slight increase in the M-1 rate.

Mr. VOLCKER. The same or slightly higher.

Senator DECONCINI. That is bound to have some effect on interest rates, is it not?

Mr. VOLCKER. The growth in the money supply has an effect on interest rates relative to other things happening in the economy, but it cuts two ways. In the short run, you would expect with less money, more pressure on short-term interest rates. But that relationship, that traditional textbook kind of short-run relationship, also has to be looked at in the context of how the market will react to it over a period of time. If the conclusion is that more money will lead to more inflation over a period of time, that will result in higher interest rates. It is a complex relationship.

### INCREASE IN MONEY SUPPLY

Senator DECONCINI. If the administration pursues what it considered a tight monetary policy, and with your discussions with the President recently, if you discussed that and can share it with us, is the administration's policy to increase that money supply above 5 or 6 percent?

Mr. VOLCKER. We, of course, have to make the decision, but there has not been any disagreement with the administration. They have been supportive of the notion of keeping the money supply growing at a moderate and declining rate and have said so.

Senator DECONCINI. Have they consulted prior to those decisions at all?

Mr. VOLCKER. I have had discussions with members of the administration. I did not consult them in the sense of asking what do you think we should do. But we are in communication.

Senator DECONCINI. Is it your intentions in 1982 and the Board members to keep it at below 6 percent?

Mr. VOLCKER. Our target on a fourth quarter to fourth quarter basis is 2½ to 5½ percent for M–1 and 6 to 9 percent for M–2. We indicated at the time we adopted those targets that based upon what we know now—and I keep emphasizing that because there may be changes in the market that we don't anticipate of a technical character or an institutional character—we would find an outcome in the upper part of that range for M–1 satisfactory, in the 4 percent, 5 percent area. We also said with respect to the M–2, while the target is 6 to 9 percent, we thought it more likely that M–2 would run toward the upper part of its range too. That would allow for some decrease from last year, but we look more toward the upper part than the lower part of that range.

Senator DECONCINI. Thank you, Mr. Chairman.

Chairman HATFIELD. Thank you, Senator DeConcini.

## PREPARED STATEMENT

Thank you, Mr. Volcker. We appreciate your presence here with us this morning. Your prepared statement and submitted questions with answers will be inserted in the record at this point.

[The information follows:]

# PREPARED STATEMENT OF PAUL A. VOLCKER
## CHAIRMAN, BOARD OF GOVERNORS
## FEDERAL RESERVE SYSTEM

I appreciate this opportunity to discuss with you important economic issues that are of concern to all of us. Obviously, interrelationships among monetary, fiscal, and other policies have important bearing on our national economic performance and, especially, on the performance of our credit markets. The Federal Reserve has responsibilities only for monetary policy. This Committee has a leading role in determining federal spending and, through that avenue, in determining federal demands on credit markets. Although this Committee must deal with a great many specific program details -- all of them beyond the purview of the Federal Reserve -- the sum of your actions and their longer-term implications are directly relevant to monetary conditions and economic prospects.

Clearly, the economy is going through troubled times. Unemployment is painfully high, particularly in older industrial regions. Interest rates are imposing severe strains on housing, small business, and agriculture, and on thrifts and certain other financial institutions. These problems are in major part a legacy of high inflation and lagging productivity growth over a number of years.

I believe that there are strong reasons to expect a cyclical upturn later this year. Our monetary policy targets will accommodate such an upturn. And the deficit for the current year, with its large cyclical component, should be manageable; to a considerable extent, by supporting income flows and spending during the recession, it can help stabilize the economy and induce recovery.

For future years, the situation is quite different. We face the bleak prospect, as things now stand, and without strong action to contain spending and to increase revenues, that budgetary deficits will rise very substantially, even assuming satisfactory economic growth. That prospect threatens the recovery in business investment and housing we need by potentially preempting a sizable fraction of our savings potential; moreover, the future implications for congested credit markets feed back on present interest rates, as lenders and borrowers "discount" what might happen in the years ahead. While it might be argued that larger growth in the money supply, now or prospectively, could relieve the pressure, one result would be to renew fears of inflation, just as marked progress toward greater price stability is apparent. An inflationary increase in the money supply cannot substitute for real savings, and, in time, would result in higher rather than lower interest rates.

Clearly, the potential problem before us lies squarely at the intersection of monetary and fiscal policy, and of our respective responsibilities. For that reason, I should like, first, to review the recent and prospective course of monetary policy and then to discuss its relationship to the fiscal problem.

Monetary policy has, of course, been directed toward restraining growth in money and credit with the important objective of reducing inflationary pressures and placing the economy on a course toward price stability. The hard fact is that uprooting a deeply embedded inflationary process is difficult; it is made even more difficult to the extent the effort is concentrated on one policy instrument. The fact that interest rates have remained painfully high in the midst of recession, restraining activity in credit-dependent sectors of the economy is one reflection of the difficulty. But the problem extends back over a number of years. As you know, the current recession has been superimposed on a pattern of stagnation extending over a considerable period.

In broad terms, I don't think there is any great mystery as to why the economy has behaved this way. Beginning in the mid-1960s, inflation increasingly became a way of life, and in the process distorted economic incentives, sapped our productive energies, and caused arbitrary and capricious transfers of income and wealth. For a time, as inflation gained momentum, real interest rates were low or negative. But after inflation took hold, and became embedded in behavior and expectations, anticipations by borrowers and lenders alike tended to propel interest rates higher. And, as monetary policy moved to deal more forcefully with the inflation -- particularly in a context of fiscal imbalance -- the strain on financial markets became more acute.

The alternative course of simply accommodating inflation by providing it monetary sustenance would, however, offer no lasting relief. By feeding expectations of inflation and reinforcing the reluctance of lenders to commit funds for any but the briefest periods of time, the high level of interest rates (particularly long-term rates) would only become further embedded in the economy. The hard fact is that loss of our most important financial yardstick -- a stable dollar -- bred high and volatile interest rates. Restoration and maintenance of lower interest rates is ultimately dependent on greater confidence that stability can and will be restored.

Developments during 1981 seem to me broadly consistent with that effort. While particular measures of money and credit diverged, responding in large part to legislative, regulatory, and institutional change affecting the way businesses and individuals chose to hold their financial assets, the general direction was consistent with the effort to curb the monetary sources of inflation. Specifically, M1B growth (adjusted for the estimated shift of funds into NOW accounts) decelerated further last year, averaging a little more than 1 percent lower than the previous year -- the third consecutive year of such deceleration. Growth of the broader aggregate M2 averaged a bit higher than in 1980, but that rise, at the margin, reflected extraordinary growth in money market funds and regulatory and legislative changes affecting the attractiveness of time deposits, which pulled into M2 some funds that otherwise would have been placed elsewhere.

Despite the slow growth of the narrowly defined money supply, short-term interest rates fell substantially from mid-year peaks, particularly sharply after the recession took hold. As you know, however, short-term rates retraced part of that decline late in the year and early in 1982. The money supply rose particularly sharply in the early weeks of 1982, and as a result, bank reserve positions came under renewed pressure. A spurt in money growth is unusual in a context of weak production and income, and it appeared at least partly related to uncertainties on the part of individuals, leading them to shift a portion of their financial assets into the most liquid form. More recently, the excessive growth has appeared to be subsiding, and interest rates have turned somewhat lower. But a characteristic of the past year has been the persistently high level of intermediate- and long-term interest rates, an area of the market most heavily affected by expectations.

Those interest rates have remained high despite visible progress -- and potentially lasting progress -- on the inflation front. To be sure, some of the progress against inflation reflects the more immediate, and potentially reversible, effects of recession-weakened markets, current surpluses in petroleum and grain production, and reduced commodity speculation and pressures generally for inventory liquidation due to extraordinarily high interest rates. However, we can now also see encouraging signs of more lasting progress. Attitudes of business and labor toward pricing and wage bargaining, and toward work rules that hamper productivity, seem to be changing. Not surprisingly, that is most clearly apparent in industries where costs and wages have been most clearly out of line and where international competitive pressures or those resulting from regulatory change are particularly intense. But -- so long as monetary and fiscal policies are appropriate -- I believe these changes will be reflected in a spreading pattern of cost and price restraint. Individually, workers and businessmen are naturally reluctant to maintain such restraint, partly for fear their concessions will not be matched by those of others. But collectively, such restraint, combined with higher productivity, will be amply repaid in the form of higher real wages and better prospects for job security. This is the foundation on which we can expect to build a sustainable recovery.

If these brighter prospects are to be achieved, however, we cannot afford -- just as the disinflationary process is beginning to take hold -- to abandon our monetary vigilance. Past failures to "carry through" have left a legacy of skepticism and uncertainty among workers and businessmen, among consumers, and, not least, among participants in financial markets where lenders demand "inflation" and "uncertainty" premiums when committing their funds. That is one important factor holding up longer-term interest rates. Credibility in dealing with inflation will have to be earned by performance and persistence over time. And, I believe, it is broadly and rightly recognized that appropriate restraint on the expansion of money and credit will continue to be fundamental to restoring price stability.

Our intentions with respect to money and credit growth in 1982, reported to Congress three weeks ago, seem to me consistent with that need. The monetary targets are, we believe, consistent with recovery in real business activity over the second half of the year; in fact, the target range for M1 is consistent with somewhat larger growth in that aggregate than actual growth of the adjusted measure during 1981. At the same time, the targets do assume, and are designed to encourage, further progress toward price stability. In that sense, they are a "tight fit."

The performance of the credit markets in 1982 and beyond, in a framework of disciplined monetary policy, will be heavily influenced by supply and demand forces other than the course of inflation and inflationary expectations. Key among these is the size of the federal deficit.

Government borrowing and private borrowing compete for a limited supply of available savings and credit. That competition is usually ameliorated in the midst of recession because private credit demands are reduced. But a more prosperous economy also implies much stronger needs for mortgage and business credit; indeed, sustained recovery of the private economy, and the investment we need to support productivity, is dependent on more favorable financial market conditions. It is precisely those more favorable market conditions that are threatened by prospects for sharply rising deficits in fiscal 1983 and the years beyond. Members of this Committee are acutely aware that all of the familiar projections, by the Administration, the Congressional Budget Office and private forecasters, point to historically huge deficits, assuming the Administration's defense plans are broadly carried out and no new steps are taken to curtail nondefense spending or raise revenues. We can debate whether the estimates of the Administration or the Congressional Budget Office are more accurate. But the point is that there is no disagreement that deficits would rise to $150 billion and beyond, *in a context of a steadily expanding economy*, under either set of assumptions, and deficits of those magnitudes cannot be acceptable -- not if we, in fact, want to see the rise in investment and housing we want.

Projecting the federal budgetary position for several years ahead necessarily involves a range of uncertainty about spending and tax programs, the level of interest rates, and overall GNP. Moreover, there is a range of possible outcomes with respect to our savings potential and sources of funds in the credit markets, even with given assumptions regarding the GNP. Nevertheless, some general implications of the budgetary outlook as it stands are clear enough.

*In the absence of action*, the projected deficits would be outside the range of peacetime experience for good business years, whether measured in absolute terms or in relation to the potential GNP and savings.

In recognition of those concerns, the Administration has proposed large cuts in spending and some measures to increase revenues. Such action would go a long way toward bringing the deficits down, cutting them by one-half or so in fiscal 1984 according to Administration estimates. But even with such forceful action, the size of the projected deficits would remain large, relative to savings and the GNP, for a relatively prosperous business year. While a few years in the 1970s appear roughly comparable, there would appear to be little or no "safety margin" for meeting expanded investment requirements. Should the deficit trends be more adverse, as the Congressional Budget Office suggests, the potential for "crowding out" private investment would be greater.

A substantial increase in savings could help protect against the implied squeeze on financial markets. Indeed, business saving is likely to be enhanced substantially by the provisions of last year's tax bill and personal saving should also be increased as inflation declines and in response to other incentives. But we also need to remember that the larger savings potential should not be dissipated in financing government purchases or transfer payments when our investment needs are so urgent.

The hard fact is we cannot escape a choice -- whether we want to encourage more favorable financing conditions for the private sector or whether we are willing to risk seeing our savings and financial resources diverted in large measure to financing a federal deficit.

While it is the deficits for fiscal 1983, 1984, and beyond that loom so large, action is needed now for several reasons. First, as you know, the budgetary momentum cannot be curbed without planning ahead. Steps to achieve large reductions in spending or higher receipts in fiscal 1983 -- only six months off -- need to be put in place soon, and measures of spending restraint should be undertaken during the current Congressional session to be fully effective in fiscal 1984.

Second, deficits of the projected magnitude are in some degree self-reinforcing. Prolongation of high deficits and high interest rates feeds back into future debt service and budget expenditures.

Finally, and most important, uncertainties about future credit market pressures cloud the planning of investors today. Strong actions taken now to assure that deficits can and will be reduced as the economy recovers can go far toward galvanizing investor attitudes in a favorable direction. Paradoxical as it may seem in the light of some past economic analysis -- analysis developed when inflation and high interest rates were not a preoccupation -- prospects for recovery can be speeded by decisive action by this Committee and your Congressional colleagues to curb future deficits, for the result would be to relieve apprehension in the market that contributes to today's high rates.

As I noted earlier, if enacted, the proposals by the Administration for deficit-reducing measures totaling over $55 billion in fiscal 1983 and approaching $85 billion in 1984 would go a long way toward ameliorating the potential problem. They represent a major challenge to the Congress, but I would urge upon you the desirability of going even further to reduce demonstrably the pattern of deficits as the economy recovers. The appropriate target, it seems to me, would be to restore the prospect of budgetary balance as a high level of economic activity is restored.

On purely economic grounds, I believe that lower taxes will enable the economy to perform more effectively and that higher marginal tax rates distort incentives and impede economic efficiency. But you must weigh many considerations, and I recognize the choices before you are extremely difficult and involve detailed considerations of social objectives and program objectives beyond the purview of the Federal Reserve. To the extent that the job cannot be accomplished by further steps to reduce spending growth, I see no alternative but action to bring the trend of revenues into better alignment with spending prospects.

In concluding, I would emphasize that the main directions of economic policy laid out last year seem to me broadly appropriate to the challenge before us. We are making progress against inflation, and sustaining that progress is fundamental to a brighter future. Tax and other policies developed last year should contribute to a more productive, competitive economy. Some steps have been taken to slow the strong upward momentum in Government spending.

At the same time, the agenda for action is clear. The Federal Reserve will maintain the needed degree of monetary discipline. We need decisive action to curtail budget deficits.

As we approach that agenda, I can only be encouraged by the degree of understanding of the nature and the urgency of the problems before us. I believe there is a sense that, difficult as it is, the Congress and the Administration have an opportunity in coming weeks to seize the initiative with a strong budgetary program. We in the Federal Reserve mean to do our part in fostering confidence in financial markets. Together, we can move from challenge to conviction that the base has been laid for national recovery.

# QUESTIONS SUBMITTED BY SENATORS HATFIELD AND STENNIS

Chairman Hatfield: Reacting to criticism that money growth has not been stable, you recently stated that "we pay too much attention to stability. What counts is the trend over time." What do you believe is a fair period of time to expect stability? A year? A quarter?

Chairman Volcker: There's no simple, clear-cut answer to this question. It should be stressed, first of all, that there is no evidence that offsetting fluctuations in the growth of money over a period of a quarter or two leaves any significant imprint on the economy. Thus, it makes sense to focus on longer periods of time in gauging the "stability" of monetary growth--or perhaps more aptly, the steadiness of monetary policy. But the monetary growth trends that are truly of greatest importance in the present environment probably relate to spans measured in years. What we need is money growth on average over the next few years at a rate below the average pace of expansion in the past few years--and a confidence on the part of the public that before very long this sort of measure of the trend growth of money will match the requirements of an economy growing in line with potential output with stable prices. With such confidence, the inflation premia in interest rates will disappear and nominal wage demands will subside toward rates consistent with the growth of labor productivity.

Chairman Hatfield: You have suggested that a "sustained" attack on inflation is required to reduce inflationary expectations. What period of time meets your "sustained" test?

Chairman Volcker: I have no fixed timetable. The main point to be made is that any shifting away from anti-inflation effort is likely to lead quickly to a reversal of the progress we've made toward a moderation of wage and price increases. Moreover, our next attempt to rein in inflationary pressures is likely to prove even more difficult--and more costly in terms of economic disruption--because another episode of stop-go will have caused inflationary expectations to become more deeply entrenched.

Chairman Hatfield: The chief economist for a Wall Street investment company recently made this statement: "Unless immediate action is taken to narrow current and prospective budget deficits, interest rates and the dollar could climb to a point where a worldwide depression would become a serious possibility. Because the current recession stems largely from an overvalued dollar, it is far more dangerous than previous downturns." What is your reaction to this statement?

Chairman Volcker: The assertion that action is needed to reduce budget deficits seems completely accurate to me, but I would not attach such particular importance to the exchange rate consequences or see as likely a worldwide depression. The relatively high level of U.S. interest rates and the foreign exchange strength of the dollar do have international implications, and a number of foreign officials have spoken out about the link between large prospective U.S. budget deficits and high interest rates. As regards the current recession, while a rising dollar has tended to weaken demand for U.S. exports and to increase demand for imports (and at the same time helped to damp domestic inflationary pressures), I think it an overstatement to attribute the slump largely to an "overvalued dollar."

Chairman Hatfield: The Administration has argued that the increased savings made possible by the tax cut will enable the economy to absorb the record federal deficits being projected. For 1981, one estimate is that individuals saved $100 billion, and businesses $372 billion. The federal deficit was 12% of the total of business and individual savings. The President's Council of Economic Advisers projects that individual savings will rise to $170 billion in 1983, and business savings to $470 billion in 1983. Do you believe these are realistic figures? Would they support the projected federal deficit without denying needed credit to private borrowers?

Chairman Volcker: I think it would be fair to say that the Administration's projections of savings are on the optimistic side, given historical patterns. Any projections of this kind have a considerable margin for error, and I recognize that reduced inflation, lower taxes, and other factors are likely to result in a higher savings rate than in recent years. However, I do not believe it prudent to assume so dramatic a change in a relatively short period of time at the edge of, or beyond, historical experience. In light of these uncertainties, I have argued that the Congress and the Administration should address the budget question with a view towards preserving a reasonable "safety margin", to provide assurance that there will be enough private savings left over to support the kind of capital formation we need to achieve better levels of productivity.

Chairman Hatfield: Washington columnists recently suggested that supply-siders in the White House had pressed the President to call on you to "end overt Fed efforts to control the money supply, curtail Fed purchases of government bonds and dust off the discount rate as the principal instrument to maintain an adequate supply of credit." What do you believe would be the result of such a policy?

Chairman Volcker: The brief quotation is not adequate to provide understanding of the particular mechanism of control that the "supply-side" commentators may have in mind. If the implication is to abandon the quantitative control of growth of monetary and credit aggregates over time, I believe there would be serious adverse consequences for the credibility and success of our efforts to deal with inflation, and potentially for interest rates and economic activity. The more technical question of the relative emphasis on the discount rate and open market operations is a matter of continuing judgment, but in general we have believed more vigorous use of the discount rate instrument in seeking monetary control would result in greater instability in market rates.

Chairman Hatfield: Yale professor James Tobin recently made this statement: "It is not that monetary policy is colliding with fiscal policy, it is colliding with the economy. Monetary policy would block full recovery whether the demand fuel for recovery were government spending for defense, private spending of tax cuts, or entitlements, or spontaneously buoyant private investment or consumption." What is your reaction to this statement?

Chairman Volcker: There is no doubt that restraint on monetary and credit growth imposes some general limits on the growth in nominal GNP. Monetary policy concerned with inflation inevitably has that consequence. The purpose, of course, is to the extent possible, to restrain inflation rather than real growth, in the conviction that, over time, the economy will not prosper in an inflationary environment. We do feel that our monetary growth targets are consistent with recovery, and a resumption of sustained economic expansion so long as inflation does continue to trend lower. Far from inhibiting "full recovery", I would question whether full recovery is possible without simultaneously dealing with inflation. That seems to me the lesson of recent history.

The sense in which monetary policy may be said to be colliding with anything is that the prospect of growing budget deficits—absent major action by the Congress and the Administration--tends to intensify credit market pressures, inhibiting the private capital formation we'd all like to see.

Chairman Hatfield: Chrysler Chairman Lee Iococca has argued that while there is plenty of money for the U.S. Treasury to borrow, and plenty for DuPont to buy Conoco and Sears to buy Dean Whitter, there is no money available for the purchase of autos and housing. As a result, these industries, which create jobs by additional sales, are in desperate condition. So he believes in credit allocation, and argues that the Federal Reserve should nudge the banking community to supply credit at more favorable rates to job-creating industries such as housing and autos. What is your response to this view?

Chairman Volcker: One should note that no system of credit allocation is going to reduce the Treasury's claim on the nation's financial resources, except that "allocation" implicit in control of the deficit. Acquisition loans account for a small fraction of bank credit, and typically reflect a transfer of funds from one set of asset holders to another, without an equivalent drain on the net resources available in capital and credit markets. Consequently, I do not believe control of takeover loans would in itself represent a significant contribution to investment in housing or autos--or other capital goods, for that matter.

Efforts to direct credit to particular uses, especially in a complex, highly decentralized, sophisticated financial system like ours, are severely limited in their potential effectiveness by the fungibility of money. Experience does not offer much support to the idea they would make a significant contribution to capital market effectiveness or efficiency.

Chairman Hatfield: One Wall Street economist has stated that while the whole thrust of fiscal policy is expansive, monetary policy is anti-growth, and that this contradiction has resulted in the punishing level of interest rates and the present recession. Do you believe this is an accurate assessment?

Chairman Volcker: I don't think I'd put it in those specfic terms, but I have repeatedly made the point that excessive reliance has been placed on monetary policy to fight inflation and that a more restrained fiscal posture would do much to ease the financial strains that have accompanied this effort.

Chairman Hatfield: What differences in effect on the economy are there between removing money from the economy by borrowing, and by taxing?

Chairman Volcker: The difference is substantial. Taxation removes funds from the spending stream directly, with important effects (depending upon the nature of the tax) on consumption. The effect of borrowing on financial markets is potentially absorbing savings that would otherwise be available for investment. The relative advantages and disadvantages of the two approaches depend on particular economic circumstances. When potential private savings would otherwise not be fully employed, deficits may be appropriate. The circumstances are quite different when congestion in credit markets is evident, high interest rates restrain growth, and when policy should be directed toward facilitating more investment. In present and foreseeable circumstances, the importance of dealing with the deficit (and actual and potential capital market congestion) seems to me evident.

Chairman Hatfield: A recent article in the National Journal indicated that some economists have tracked money growth in 1980 and 1981 according to the political calendar and the expressed wishes of executive branch officials. For example, in October 1981 Secretary Regan's statement that the Fed has "held too tightly on the monetary reigns" and that "We are coming to a time when a change has to be made" preceded the much larger growth of money in the last weeks of 1981. What is your reaction to these changes?

Chairman Volcker: There was no connection between such remarks made by executive branch officials and the actions of the Federal Reserve. The stronger growth of M1 over the last weeks of 1981 was quite consistent with the annual target set by the Federal Open Market Committee--since that aggregate had been below the FOMC's range and indeed ended the year below the range.

Chairman Hatfield: On July 1 this year, the second and larger cut in personal income tax rates goes into effect. Since the beginning of the Reagan Administration and throughout the debate over tax cuts last year and the testimony of Administration witnesses this year, the idea has been that these tax cuts would increase the pool of savings. How can Americans save more if your target for their savings accounts is the same as the rate of growth in M2 prior to the tax cuts?

Chairman Volcker: M2 does encompass a portion of the savings of the public. But there are many other forms as well. We have indicated that, should changes in the public's asset preferences warrant it, we would be quite prepared to reassess our ranges for the monetary aggregates; we certainly have no intention of following slavishly any particular numerical target if the realities indicate that they are inconsistent with the basic objectives of slowing inflation and fostering conditions conducive to a resumption of sustainable growth. At present, we believe those targets are consistent with the likely increase in savings.

Chairman Hatfield: Lately you have indicated that you intend to keep to the high side of your 2.5% to 5.5% target range for M1. Can we expect that you will keep M1 above 5% for the rest of this year?

Chairman Volcker: As regards the M1 growth for the year, we have not narrowed our sights to the 5 to 5-1/2 percent zone; rather, we have said that, in light of recent indications regarding the public's financial behavior and the relatively low growth last year, we would find an outcome in the upper part of its 2-1/2 to 5-1/2 percent range acceptable. To specify a narrower outcome, such as "above 5 percent," would imply a greater degree of precision in monetary control than in fact exists.

Chairman Hatfield: Under your monetary policies, it is rational for everyone to minimize their holdings of cash, demand deposits and passbook savings and maximize their use of money market funds and small denomination time deposits at market rates. The record shows that people are being rational. Between September 1979 and December 1981, currency and checkable deposits (M1) have declined as a percentage of M2 from 25.4% to 24.0%. Passbook savings accounts have declined absolutely by $110 billion dollars, and as a percentage of M2 from 29.6% to 18.2%. Meanwhile money market funds have grown by $150 billion dollars and small denomination time deposits have grown by $234 billion dollars. Thus, people are getting market interest rate returns for more of their idle funds. Aside from changes in interest rates, this reallocation of assets from non-yielding or low yielding accounts to high yielding accounts is estimated to have increased the overall return on all of M2 by at least 1%. My question is this: Doesn't this shift in the composition of M2 mean that M2 is automatically growing faster now due to higher payments of interest on this different allocation of deposits?

Chairman Volcker: It is indeed the case that, with the emergence of money market funds as an important investment outlet and with the liberalization of the ceiling rates on small denomination time deposits, M2 now contains a number of assets whose returns move with market rates of interest. In an environment of relatively high returns in the market, M2 growth is faster than would be the case if deposit interest ceilings were held below market rates. This change in the performance of M2 is only one of a number of influences that the Federal Open Market Committee considered in its deliberations regarding setting of the long-run monetary targets.

Senator Stennis: I have heard that if our money supply were increased at a higher rate than we have in the past year, that interest rates would fall and that there would not be a significant increase in inflation if we were careful to increase the money supply gradually. I would very much like to hear your comments on this.

Chairman Volcker: I cannot say whether interest rates would fall or not in the short run. This would depend on a number of factors besides the growth of money--such as the size of current and prospective federal credit requirements. The Federal Open Market Committee has indicated that--based on what we know at this juncture--a faster growth of the narrow money stock (M1) this year than last would be consistent with our longer range program for slowing inflation and revitalizing the economy. We have indicated that growth of M1 in the upper part of our 2-1/2 to 5-1/2 percent range for 1982 would be acceptable; last year M1 grew 2-1/4 percent on a fourth-quarter to fourth-quarter basis (after adjustment for the effects of shifting into new NOW accounts).

Senator Stennis: Mr. Volcker, in your estimation how much of a reduction in the deficit this year and future years will be required to bring down long-term interest rates to a level which would permit economic recovery.

Chairman Volcker: I have recommended that the Congress enact deficit-reduction measures that total at least as much as the President has recommended in his FY 1983 budget, if not more. This is a necessary action in its own right and is also a precondition for setting the budget on a better course for 1984, '85 and beyond. Such action would provide much encouragement to the financial markets and help to foster the private capital formation we need for a sustained, balanced recovery and expansion. I am less concerned about the deficit for the current year because it is to a considerable extent a reflection of the recession. The concern is properly with regard to the budget situation once the economy begins to recover.

# NONDEPARTMENTAL WITNESSES

## STATEMENT OF LOUIS KELSO, CHAIRMAN, KELSO AND CO.

### PREPARED STATEMENT

Chairman HATFIELD. Our next witnesses are Louis Kelso and Patricia Hetter Kelso, a husband and wife team of rare intellect. Our witnesses have developed a concept of social capitalism, the goal of which is to distribute our now highly concentrated economic resources more widely through our population via mechanisms such as employee stock ownership plans.

Dr. Kelso, before moving on to your testimony we will insert your prepared statement in the record at this point.

[The statement follows:]

## PREPARED STATEMENT OF LOUIS O. KELSO

### CONGRESS, THE CONSTITUTION, AND THE ECONOMY*

> "We hold these truths to be self-evident: that all men are created equal; that they are endowed by their Creator with certain inalienable rights; that among these are life, liberty, and the pursuit of happiness. That, to secure these rights, governments are instituted among men, deriving their just powers from the consent of the governed. That, whenever any form of government becomes destructive of these ends, it is the right of the people to alter or to abolish it and to institute new government, laying its foundation on such principles and organizing its powers in such form as to them shall seem most likely to effect their safety and happiness . . . ." (Extract from the Declaration of Independence, July 4, 1776.)
>
> "We the people of the United States, in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defense, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do ordain and establish this Constitution for the United States of America." (Opening paragraph of the Constitution of the United States of America.)
>
> "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land . . . ." (Article VI of the Constitution of the United States of America.)
>
> "No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." (Amendment V.)
>
> ". . . No State shall make or enforce any law which shall abridge the privileges of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." (Amendment XIV.)

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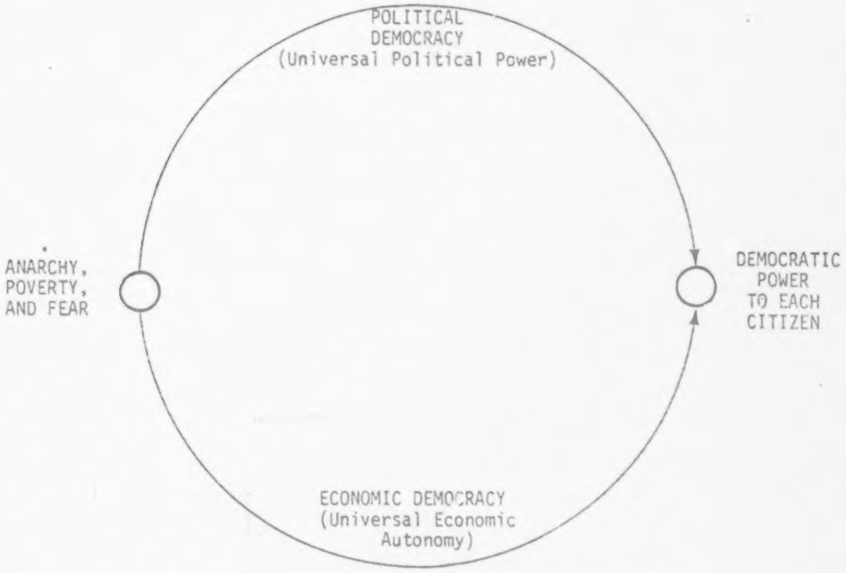
* Copyright 1982, Louis O. Kelso and Patricia Hetter. This testimony is based in part upon earlier writings, beginning with the publication in 1958 of The Capitalist Manifesto (Kelso and Adler, Random House, New York, and Greenwood Press, Westport, Connecticut) and continuing with publication of The New Capitalists (Kelso and Adler, Random House, New York, 1961, and Greenwood Press, Westport, Connecticut), Two-Factor Theory: The Economics of Reality (Kelso and Hetter, Random House, 1967), and upon Social Capitalism: Who Should Produce the Wealth of Nations? by Kelso and Hetter, to be published later this year.

DEMOCRACY


POLITICAL DEMOCRACY (Universal Political Power)
ANARCHY, POVERTY, AND FEAR
DEMOCRATIC POWER TO EACH CITIZEN
ECONOMIC DEMOCRACY (Universal Economic Autonomy)

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It is the thesis of my testimony that the Declaration of Independence and the Constitution of the United States, interpreted in the light of American history and world history, promise us — the American people — democracy; that only through our democratic example to the world, not through our military might, nor by our meddling in the affairs of other nations, nor by our setting them at each other's throats through "strategic arms sales," can we cause our political economy to be imitated by other countries.

We find no instance in the annals of history of the destruction of a wrong idea — like the idea of socialism or communism — by bullets, bombs, napalm, chemicals, missles, battleships, submarines, armies, or navies. Bad ideas are destroyed only by good ideas; wrong ideas are corrected only by right ideas.

The United States today is not yet a constitutional democracy. It is a tantalizing but cruel mixture of political democracy and economic oligarchy. Each citizen has a vote at political elections, but the bulk of the economic productive power of the society is held by a tiny minority — five percent of the population. Today, substantially all of our nation's mighty capital instruments are owned by this minority. It will own the new capital instruments of tomorrow.

A political democracy that is not an economic democracy is but half democratic. It contains the seeds of its own destruction, as Marx and Engels maintained. At the same time, it contains the seeds of its own democratic perfection. Congress, and Congress alone, can determine which of these seeds shall flower.

## Glossary

My statement today deals with an idea which may be new to many — the idea of Social Capitalism. Communication will be easier if some terms are defined.

Economic Democracy: Economic democracy exists when every citizen personally owns and possesses the power to produce the income he needs to support and enjoy the lifestyle he reasonably chooses for himself and his dependents. For more than two centuries, we have been moving away from this ideal. Day-by-day, the many are increasingly dependent upon welfare, boondoggle (welfare disguised as jobs), charity, and redistribution. With negligible exceptions, the rich owners of productive capital — the capital workers who make up about five percent of the population — are economically autonomous. Of the remaining 95 percent, some earn their living by their labor, although often their labor income is bulwarked with welfare disguised as labor pursuant to our full labor employment national economic policy. Others are reduced to living openly on welfare and charity.

Social Capitalism — The political economy of a nation state characterized by an economic democracy within a political democracy.

One-Factor Economics — Any economic theory that fails to regard capital and capital workers as factors of production in the same functional senses that it regards labor workers as a factor of production is a one-factor theory. This includes Keynesian demand-lopside economics, the current fad of supply-lopside economics, and all macroeconomic concepts, past and present, other than Social Capitalism. In its failure to move toward making dependent consumers self-supporting, the new "supply-side" economics merely assures that Congress, not the President, will be held responsible for spreading the welfare state to its logical conclusion: socialism.

Labor Worker — An individual who engages in economic production through the powers of his body, physical or mental.

Capital Worker — One who engages in economic production through his privately owned capital. The capital worker's work is vicarious — he is not generally required to be present personally at the scene of production.

Say's Law — See "Morbid Capital" below.

Morbid Capital — This is a new and graphic, but accurate, name for a hitherto unrecognized phenomenon that is implicit in the structure of British common law, long ago adopted into American common law. It relates to the two historic limitations recognized by the law as inherent in the sum of property rights a man may possess in a thing he owns. These limitations are: (1) the ownership of private property does not include the right of the owner to use the property in a way which injures the property or person of another; and (2) the ownership of private property does not include the right to use that property in ways contrary to the public interest or injurious to the public welfare. Since the theory of capitalism (capital theory) recognizes both labor workers and capital workers as economic producers in the identical functional, economic, political, and moral senses, a simple but long neglected fact of life comes into focus: the purpose for which an individual in a free society may legitimately engage in production is consumption by himself and his dependents of the income he produces.

Within these limitations on private property, a man may improve, increase, and refine his capital productive power so long as that productive power is used to support his self-chosen standard of living for himself and his dependents.

However, the double-entry bookkeeping logic of a market economy, normally referred to as "Say's Law,"(*) for any given time period equates the market value of goods and services produced by each participant in production with the income distributed out of the process of production to that individual. It follows, therefore, that income in excess of that used for consumption, whatever the reason for the excess, can and will be used only to acquire additional capital productive power, which in turn produces further excess income, which in turn is used to acquire further excess capital productive power, etc., ad infinitum. Such excess productive power we call "morbid capital," because its nature, like that of cancer, is to grow without symbiotic relationship to the organism to which it is attached. Morbid capital violates the common law limitations inherent in private property because, without benefiting its owner, it deprives others of becoming economically autonomous. It is contrary to the public interest because it makes the economy not only unworkable but economically undemocratic. It makes the majority weak, parasitic, and insecure. The morbid capital of the rich destroys the possibility of economic democracy for the poor.

Feasibility Principle — This is the reasonable expectation, arrived at after careful analysis and experienced evaluation, that a capital asset will pay for itself, i.e., throw off net income equal to its costs of acquisition within a planned period of time (the rule of thumb in business is three to five years), and thereafter, its productive power preserved by proper maintenance, depreciation policies, and research and development, continue to produce income for its owner indefinitely. "Feasibility" is the basic logic of capital acquisition in the business world. Whether articulated or not, it has always been.

Collateralization Principle — This is a precaution universally employed in the United States since 1776 in financing the acquisition of capital assets; it reinforces feasibility logic. "Collateralization" is what occurs when an individual buys stock for cash or puts assets at risk through mortgage or other type of incumbrance to finance purchase of other assets. Collateralization serves an insurance function, insuring against the risk that the acquired asset may not pay for itself as contemplated by the feasibility plan.(**)

Not only is collateralization a crude, inefficient and enormously expensive way of insuring the feasibility risk in capital financing, but there are decisive social and political reasons why it should not be used. It limits access to credit to buy capital to those who already own substantial amounts of capital. We call this the "Divine Right of Kings —

(*) See illustrations, Pages 39 and 40, post.
(**) See The New Capitalists, Kelso and Adler.

American Style," because it serves the same function in the American economy and in other modern economies as the Divine Right of Kings did for hundreds of years in Europe: it keeps all of the capital within the top five percent of the population! The economic function of collateralization, from every logical aspect, should be treated as a casualty insurance problem, because it *is* a casualty insurance problem. We call such insurance "capital diffusion insurance."

Not only is casualty insurance the oldest of the financial arts, but the cost of such insurance is minimized by competition and constantly adjusted to market experience.

The "feasibility" assured is the feasibility of the enterprise in which the credit-financed investment is being made. The insurance is thus not personal to the investor. The performance by him of his duties — initially to apply the yield of the assets he acquires to repayment of the debt and interest — is automatically taken care of by the ESOP-logic in the contractual design of the financing vehicle.(*)

1. By relying on the feasibility principle, backed up by capital diffusion insurance and financed through pure credit, we can open up the opportunity to buy productive capital to anyone, through use of the eight financing techniques designed to implement capital theory. Since the earliest and most extensive uses of capital implementation technology will undoubtedly be in the largest and best established businesses, municipalities and utilities, the cost of capital diffusion insurance should be negligible.

Up to now, the costs of our not having rationalized the phenomena of finance and of individual ownership of capital into a feasibility problem plus a casualty risk insurance problem have caused those costs not to be primarily borne by entrepreneurs, businesses, financiers, or financial institutions, but by the society as a whole. To reckon such costs, one would have to add all costs that would have been, and would hereafter be, eliminated if we had had, and henceforth have, an economically democratic nation, i.e., a nation of economically autonomous consumers. The unnecessary costs that would be eliminated by capital diffusion insurance would include:

- All transfer payments in the economy. In 1980, at the Federal level alone, these amounted to half of the U.S. budget. The burden at the state level is comparable, even with the "New Federalism."
- A major part of all private business debt, public debt, and debt incurred for private capital investment, since such debts, financed through

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(*) See diagram, Page 33, post.

the use of capital theory methods, would enable them to self-liquidate and fully convert into equity in about five years. The warehousing of morbid capital, so cherished by its owners and their financial helpers, would graudally fade away.

— The costs of public and private pension plans and profit sharing plans would be eliminated in favor of portfolios of high-yield corporate equities.

— The incalculable costs reflected for the most part in misery, deprivation, and eternally lost opporuntities for a good economic life for a large part of the entire U.S. population would gradually be eliminated.

The amount of morbid capital parasitically living in the economy at any time is thus a partial measure of the burden our society — particularly its voiceless majority — bears under the Divine Right of Kings — American Style, the one-factor economists, and the tiny minority of capital-worker oligarchs.

Not only is our presently hidden economic feasibility insurance premium infinitely greater than it should be, but it is imposed on an economy that, in terms of productive capital at work for peacetime purposes, is but a fraction of what it would be if we had become a Social Captialist economy as recently as ten years ago. Not only could the enormous tangible and intangible economic costs of morbidizing capital rather than putting it to work for economically underpowered people be avoided, but the moral and political costs of denying life, liberty, and equal protection of the laws, in the sense contemplated by our Declaration of Independence and Constitution, would be reduced.

2. Neither the capriciousness of the owners of morbid capital, nor the quantitative limitations on the amount of morbid capital available to finance growth, would any longer limit our economic growth.

3. Access to pure credit (see Pages 30 to 31 herein) and capital diffusion feasibility insurance would free corporations of the need to finance growth internally in after-tax dollars. Not only would this "take the brakes off" corporate growth, but private property could be restored to stockholders who would then collect the wages of their capital as regularly as labor workers collect the wages of their labor. Broadening the ownership of capital through Social Capitalism only makes sense if capital workers systematically collect the full wages of their capital. These are about twelve times the average yield of equity stock to stockholders today.(*)

(*) State and federal corporate income taxes, together with the employer's share of Social Security taxes, on the average take over 50 percent of corporate income. The boards of directors, lacking a rational method for financing corporate growth, then take from stockholders 3/4ths of the after-tax income remaining. Minor leaks in the property pipeline running from assets to stockholders reduce this trickle from less than 1/8th to 1/12th.

4. The size of corporations, which more than anything else in the U.S. economy today reflects the aggregations of individual holdings of morbid capital, would shrink to the limits dictated by functional efficiency and competition.

5. The economic support of the underproductive 95 percent of the population, made up of consumers who do not today own capital and who, even if they did, would not collect more than a tiny fraction (1/12th) of the wages of their capital, can effectively be shifted to the vast body of mostly not yet born nonhuman slaves — productive capital — that through equity stock holdings will come to be individually owned by the present economic underperformers.

## Why the American Economy Does Not Work

The unemployment of labor workers in the U.S. economy, if we count as employed those who hold boondoggle jobs synthesized pursuant to our misguided economic policy of "full (labor worker) employment," presently averages about ten percent. However, the unemployment of potentially ready, willing, and able capital workers is at least 95 percent of the potential capital work force. Thus, in terms of total work force (labor workers and capital workers), we are perhaps 60 percent unemployed. If we adjust that estimate to treat the holders of "created" or boondoggle jobs as unemployed, which in reality they are, unemployment of our potential work force is at least 80 percent!

## Social Capitalism

In a market economy, each participant on the economic stage (each citizen) is a consumer who fills one of the following roles:

— He produces an adequate income through his labor, or capital, or through both; or

— He does not produce an adequate income; or

— He produces through his labor, or through his capital, or through both factors an adequate income plus sufficient additional income progressively to enlarge his capital productive power to a multiple — often a large multiple — of the income required to satisfy his consumer needs and wants. This excess is "morbid capital."

The phrase "adequate income" here refers to an income adequate to support the self-chosen consumer lifestyle of the individual producer.

The principal rules binding these participants, if the economy is a Social Capitalist one, are the following:

1. The ideal economy (and the ideal status of individuals within it) is one in which each consumer himself produces, either as a labor worker, or as a capital worker, or as both, the level of income required to support his self-chosen lifestyle. Where a consumer unit consists of more than one individual, the rule applies to the consumer unit. This is economic autonomy and economic democracy.

2. Except for the insufficiently educated, the untrained, or the inexperienced, the labor-productiveness of a consumer cannot, by means acceptable to working people, be increased.

3. But the productiveness of a capital worker can easily be increased through his credit-financed acquisition of capital and through technology, which progressively raises the productiveness of capital workers, but not of labor workers. One purpose of technological innovation is to reduce production costs — primarily labor costs.

4. Real jobs cannot be "created." They arise only in response to consumer demand. When the consumer demand for them is eliminated through automation or whatever, they vanish. Honest market demand for labor employment arises only when consumers, freely spending their own funds, purchase things produced by labor workers.

5. With governmental assistance, however, apparent jobs or boondoggle jobs can be created. Boondoggle is welfare disguised as jobs to save the face of the beneficiaries and to confuse taxpayers and consumers who, as unwilling hosts, must pay for it. Like all welfare, whether disguised or not, it is inflationary.

A Social Capitalist economy can be and should be operated to rely upon freely competitive markets to accomplish all valuation and income distribution functions, while assuring the productive vigor of every consumer. A Social Capitalist economy would be free of welfare, boondoggle, and inflation.

It is clear, however, that government, too, must abide by Social Capitalist rules. Two-factor economics provides the system logic, and the eight financing tools discussed below, together with pure credit, provide the implementation logic for transforming our primitive capitalist economy that works for the few into a Social Capitalist democracy that will work for all. In conformity with Blake's Law,(*) our forthcoming book, Social

(*) Blake's Law:

He who would do good to another must do it in Minute Particulars.
General Good is the plea of the scoundrel, hypocrite and flatterer,
For Art and Science cannot exist but in minutely organized Particulars.

— William Blake
(1757-1827)

Capitalism, blueprints the simple finance and credit mechanisms for bringing these conditions about.

The Constitutional Mandate For Economic Autonomy

Government, and many governmentally sanctioned and tax supported institutions, such as technical schools and universities, agricultural colleges, research laboratories, and the like, promote technological advances which eliminate millions of jobs.(*) Have the labor workers thus displaced been given "due process" in being deprived of the power to support themselves through their own labor?

It appears to us that they have not received due process, where affirmative government effort and governmentally-encouraged private effort reduces or eliminates the value of the labor workers' property, unless due steps have been taken to enable them to become capital workers.(**) This would seem equally true of employed labor workers who cannot, if their wages are competitively evaluated, produce sufficient income to enjoy their share of what labor workers and capital workers together produce. As a result of technological change, and by adding the collateralization requirement to the financing feasibility requirement, the labor worker has been unmercifully converted from an economically autonomous person (in a preindustrial period) into an economic dependent of society.(***) If he uses his political power to rig and elevate his pay, he helps to fire up inflation, of which he and the unemployed are the chief victims. And there is the additional problem of the unemployable who cannot engage in production as labor workers because of physical handicap or as capital workers because of their capital handicap.

The same conclusion must be drawn with respect to the application to the non-capital owning majority of the doctrine of equal protection of the laws. This idea is, of course, inherent in the idea of democracy as reflected in the Declaration of Independence and in our Constitution. Access to efficient and effective credit for the purpose of enabling a labor worker, or for that matter someone who is unemployable, to become a capital worker is inherent in the rights to "life and liberty." When the institutions of finance, organized under Federal or state law and regulated as quasi-monopolies by those laws, select the principle of collateralization rather than the principle of commercial risk insurance, whether from ignorance, oversight, or social

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(*) See illustration, Page 41.

(**) Politically, citizens are entitled to be economically autonomous. But competition and the state of technology determine how production is carried on.

(***) See illustration, Page 41.

indifference, it is a patent denial of equal protection of the critical laws relating to access to credit to enable oneself to become productive or more productive.

## The Priesthood of the One-Factor Economists In the United States

During the period 1929 to 1932, a breakdown in the American economy that had been building up for years took place.

We had experienced more than 150 years of progressive transfer of production power from labor workers to capital workers through technological change and through the concentration of the ownership of the growing hoard of the nation's capital in the top five percent of the population as the result of conventional finance.(1) The combination of these two forces violated Say's Law(2) to the point where we could no longer cover up or divert attention from the fact that millions upon millions of people lacked the productive power to support themselves, while a tiny minority, the rich, could not protect the values of their capital holdings in the face of the resulting collapse of consumer spending.

The economic literature of the time belabored the problem, but never identified a solution:

> "The economic system, for some reason, never succeeds in operating at full capacity. It has been observed that even in periods of prosperity we have some unutilized plant and equipment and a considerable volume of unemployment. This situation not unnaturally suggests that there must be some basic maladjustment which seriously impedes the operation of the economic machine by means of which the material wants of society are supplied."(3)
>
> "We should not be thinking about how to create new forms of wealth so as to absorb the unemployed, but rather about why our production of old and existing forms of wealth creates unemployment though our production of these old existing, and I believe more fundamental forms of wealth have never been adequate for the needs of the American people."(4)
>
> "America's capacity to produce a richly varied pattern of goods and services has been amply demonstrated. We have not yet shown a corresponding ability to maintain peacetime market demand at satisfactory levels."(5)

(1) See illustration, Page 41.

(2) See illustrations, Pages 39 and 40.

(3) Harold Moulton, The Formation of Capital, The Brookings Institution, Washington, D.C., 1935, Page 1.

(4) W. J. Ballinger of the Federal Trade Commission, in his testimony before the Temporary National Economic Committee (Hearings, Part 9, Page 3833).

(5) Paul G. Hoffman, President of Studebaker Corporation and Chairman of the Board of Trustees of the Committee for Economic Development, in Hearings on S. 380, the Full Employment Act of 1945, before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, 79th Congress, First Session, July-September 1945, Page 709.

Senator Fulbright made the same point:

> "Much has been said here about our productive capacity. We have already proved that in the war. We can produce. I don't think there is any question about that. The real problem is on the consumption end."(1)

It was in response to this deficit in consumer power that a group of "experts," fired by Keynesian demand-lopside theory, moved onto the scene to restore consumer incomes. In all that they urged, they preserved and intensified the mechanisms of wealth concentration. They carefully avoided offending the interest groups which President Roosevelt called "economic royalists." They steadily maintained, as had earlier generations of economists, including Adam Smith and Marx, that capital is not a factor of production and that capital workers do not produce goods and services in the same senses that labor workers do, but that capital is a mysterious catalytic agent which somehow makes labor workers more productive. These thousands of one-factor economists and lawyers, heavily charged with Keynesian economics, eventually grew into the powerful priesthood of one-factor economists that, in recent decades, has been the self-proclaimed fountainhead of economic "conventional wisdom" in the United States.

Their position on the function and nature of capital and capital workers has always been necessary to suppress discussion of capital morbidity. If the capital monopolist is not motivated by uncontrolled greed, but is merely providing, in the spirit of the public good, the catalytic agent necessary to raise endlessly the productiveness of labor (shades of the Puritan theory of wealth accumulation), then the greater his accumulations, the better for the economy.

Among the incredibly powerful weapons of the cult of one-factor economists is their imperialistic and artful use of preemptive wrong questions. Under their prodding in 1932, the New Deal aroused the nation from its confusion and torpor with the challenge, "How can we abolish the effects of poverty?" This powerful wrong question has mesmerized the nation for fifty years. It has consumed time, energy, institutional integrity, and even the blood and lives of the country's youths, in the vain attempt to make the economy work on Keynesian demand-lopside principles.

By proclaiming the exclusive right to credibility in matters economic, the conventional economists established power in the U.S. over man's most basic drives: his urge to survive and, beyond that, his urge to live well. The master preemptive wrong question of "how can we alleviate the effects of poverty?" was expanded into subsidiary wrong questions: "How can we prop up the incomes of the poor?;" "how can we provide

(1) Id., Page 845.

housing for those who cannot afford it?;" "how can we pay for the medical care of those who have insufficient incomes to hire their own doctors?;" "how can we educate the children of the poor?;" "how can we hire lawyers for the poor?;" etc., etc.

In spite of the growing power and personnel of the economics cult, doubts did, from time to time, arise. In 1937, at the President's request, Congress formed the Temporary National Economic Committee (TNEC), charging it with finding an answer to the question, "What caused the Great Depression?" That investigation still stands as the most massive and thorough analysis ever made of the American economy or of any other economy. With its activities guided by the one-factor economists, the Chairman of the Committee, in his closing report in 1941, announced the Committee's conclusion: "We don't know what caused the Great Depression. We only know what ended it — war production." In its September 3, 1979, issue celebrating its own 50th Anniversary, but devoting most of its pages to a fifty-year retrospective analysis of the Great Depression, Business Week confirmed that we still do not know what caused the Great Depression; we only know what ended it — war.

The apprehensions reflected in the final report of the TNEC in 1941 were again behind the activities of the Congress in 1945 when it debated the formalization of what had actually been the national economic policy from the first years of the New Deal: The Full (Labor) Employment Act of 1945. The now all-powerful one-factor economists allayed the doubts of Congress about solving the income distribution problems of our advanced industrial economy through labor employment alone by removing the word "full" from the 1945 proposed legislation and adopting a law later interpreted by the Joint Economic Committee as having the same meaning: The Employment Act of 1946. So totally did demand-lopside mania dominate the economics scene that even President Nixon eventually declared himself a Keynesian.

By 1980, the revolt against the failures of demand-lopside economics began. High income taxpayers, including the higher-paid labor workers, were outraged at the severity of income taxation and the incurring of inflationary governmental deficits to support those with no incomes and low incomes. The unemployed, the unemployable, and the holders of tens of millions of boondoggle jobs within the economy vented their frustration. They were disgusted at finding that, as technological advance makes it easier to produce goods and services, it becomes harder and harder, and even impossible, to make a living; that even with all of our great technology, mothers as well as fathers must join the labor work force, to the neglect of their children and the detriment of family life. President Ronald Reagan owes his election to the revolt against demand-lopside economics. The economic program designed for him by the one-factor economics cult who have been retreaded with supply-lopside rhetoric, continued the strategy of attacking effects, not the cause, of poverty. No deliberate or organized effort to make the underproductive and non-productive more productive was discussed or proposed. New anti-redistribution rhetoric poured forth. Military boondoggle employment was given new life, with the promise of vast manufacture of new obsolete weapons and the refurbishing of old obsolete weapons. Draft registration was revived. The great New Deal economic works, the welfare canals that channel redistributed income to the underproductive and non-productive, were closed or constricted and a burst of private-enterprise-sounding public relations proposing "federalizing" these responsibilities to the states poured forth. If demand-lopside economics was wrong and no longer acceptable to the people, then supply-lopside economics must be right; the same one-factor economic dogma, slightly redecorated, promises to mould the future in the tragic patterns of the past.

### The Economists' Use of Myths

The illusion of the validity of one-factor economics is preserved not only by the economists' art of the imperious preemptive wrong question, but by adroit propagation of big myths, or "Big Lies" as Hitler called them. Economists are in a position to do this because of the vast uncritical deference our society pays them as "experts,"(1) their formidable number — at least 100,000, mostly economists and lawyers, and their sycophantic proximity to the seats of power in and out of government. One of their most destructive deceptions is perpetuated in a single word; a word constantly on the lips and in the writings of all who are concerned with business, finance, labor, economics, or politics.

The word is "productivity." It purports to measure the productive performance of a labor worker or group of labor workers as labor workers for the purpose of comparing such performance with the "productivity" of the same persons during another period or with "productivity" of other labor workers.

There are, of course, two kinds of participants in production — labor workers and capital workers. But the capital workers, for purposes of this deception, are treated as if they do not exist, because the one-factor economics clergy never functionally treats

(1) After all, economics, while not the most important thing in life, has been at all times past the most urgent, and one-factor economics itself, by making the economy progressively more unworkable, enhances this urgency.

capital workers as engaged in production in the same senses that labor workers are. When confronted with this charge, by the way, they protest they are as desirous to see capital ownership broadened as anyone. In fact, however, they have never in their writings or public utterances urged broader capital ownership, nor have they put forward an organized effort to enable more people — millions more — to become capital workers. They have never sought to restore property integrity to capital so that capital workers would receive the full wages of their capital, thus making smaller holdings of capital significant. None of them has ever raised a voice in support of the right to be or become productive through capital ownership as the productive value of labor work shrinks. Income produced by capital work is called "unearned income" — the equivalent of the Marxists' feeble claim that the yield of capital is simply wages stolen from labor workers. Our national economic policy, that shining monument to one-factor economics, is the (Labor Workers') Employment Act of 1946. The chief instrument for constant reaffirmation of this one-factor mythology is the word "productivity."

Now "productivity" is the ratio of total output (usually in dollars) of the entity under discussion, resulting from the aggregate inputs of capital workers and labor workers, divided only by labor workers' input measured in hours or dollars. If the ratio in one measurement is higher than the other, it is said that "the productivity of labor" is higher, meaning labor in one case made a greater input than in the other, and implying, of course, that such labor is therefore entitled to higher pay. The ratio is constructed, and the term "productivity" is defined, so as to trick everyone into believing the impossible has indeed been accomplished. Mature labor workers in the last half of the twentieth century, fully aware of the fact and purpose of capital, are somehow, as workers, producing more; working harder, or smarter, or something. Capital workers are — and this is the essence of the myth — rigidly and ceremoniously overlooked, although for more than 200 years it has been the capital workers, with their technological tool prodigies harnessing ever more of the laws of nature, that are virtually the only source of increased productive input and the chief cause of the rising output of goods and services.

Quite obviously, where the input factors combine their efforts to produce a result, either the labor workers or the capital workers or both theoretically could be the source of the change. But the facts of life are that since the onset of the Industrial Revolution, and actually since long before that, labor workers have been physically providing less and less productive input, no matter how measured, and capital workers have been physically providing more and more of the productive input. On the part of labor workers, the hours of work, the intensity of toil, and the complexity of tasks have all declined over the years, while vacations, paid holidays, and interludes of leisure on the job have all increased.

On the part of capital workers, technology has relentlessly improved the productiveness of their capital instruments and they have, until the social strife between labor workers and capital workers began to interfere, consistently increased their investment in capital instruments by using their Divine Right — American Style access to financing.

By fraudulently attributing the rising production and productiveness of capital workers to the rising productiveness of labor workers and calling the result the "rising productivity of labor," the economic shamans accomplish these unbelievable results:

— They make the national economic policy of solving the income distribution problems of the society through labor employment alone appear to be workable when it is not.

— They make necessary the ever-growing redistribution of income from capital workers to non-capital workers and from higher paid labor workers to the lower paid labor workers and the unemployed. If, for political reasons, the Federal government rejects the unpopular redistribution task . . . well, there is always the New Federalism.

— They have saddled us with ever rising public and private debt, on the one hand, in order to support growing income redistribution, and on the other hand, to warehouse and maintain the value of the hoards of morbid capital of the tiny minority of capital workers.

— They preoccupy the best minds of the nation in government, business, and finance with trying to solve the great economic problem of achieving both affluent levels of production and a workable distribution of income adequate — under Say's Law — to support production. When this fails, as it must under one-factor economics, they then recommend "solutions" that only make the problem worse.

— They force the United States of America, a nation once revered as standing for a better world and a better life for each human being, to engage in activities that affront the conscience of individual Americans and threaten our common survival.

— They have destroyed 11/12ths of private property in theoretically privately-owned capital, and are well on the way to finishing the job, just as Marx and Engels predicted 134 years ago in their Communist Manifesto.

— By saturating the schools and professions with their one-factor economic falsehoods, they have provided support for the uncontrolled greed of the capital-owning five percent of the population, thus converting the invisible violence of corporate finance(1) into the political and economic alienation of the non-capital-owning majority. From this flows the rising tide of hatred of government; hatred of its leaders; hatred of the social institutions that work for the few but not for the many; and hatred of their own powerless status as wards of welfare, boondoggle, and entitlements.

To paraphrase the late Everett Dirksen, if you add up enough such charges, you begin to make a case for Congress to rethink our national economic policy.

## The Reticence of the Rich

The question naturally arises as to why capital owners as such do not take the initiative in destroying a myth that denies their status as the producers of affluence in an industrial economy. The full answer to this question is too laden with psychological undertones to discuss here. But the basic answer is simply this: How does a rich capital worker (owner) explain why he wants to produce goods and services for many people — perhaps millions of people — while only consuming for one or a few — himself and his dependents?

## The Constitution Makes Congress and the Judiciary the Guardians of Democracy: Economic as Well as Political

The disastrous fifty-year reign of the one-factor economists should be ended by Congress and the courts under the Constitution. The solution to the income production and distribution problem — how people produce and how they can consume goods and services in a civilized society — has vast national importance and equally vast international overtones. Its solution cannot be delegated to a tightly disciplined corps of self-appointed experts who, in effect, decade after decade, control the nation's economy for selfish ends that are not only irrational and destructive, but unconstitutional. Here are some of the particulars:

1. The United States was founded as the first great modern experiment in democracy. The importance of democracy to people is that it is designed to the scale of individual human beings; not to dynasties, nor to vast ownerless institutions. Democracy was conceived on the idea that power should reside in the individuals who make up a democratic society. But there are two forms of non-violent civil power. Political power,

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(1) As ever more people lose this battle for survival in the world of law and order, they turn to the underground economy where risks are higher but rewards are greater and capital credit is frequently more accessible. See "The Invisible Violence of Corporate Finance," Kelso and Hetter, Washington Post, June 18, 1972, Page F1.

consisting of the power to make, interpret, and administer the laws, and economic power, the power to produce goods and services. Political power and economic power are equally potent. Neither gives a citizen democratic power without the other.(1)

Economic democracy cannot be anything except the autonomous power of each individual (or consumer unit) to produce the income equivalent (within the overall limits of the country's resources and technology) of the lifestyle he reasonably chooses for himself and his dependents. In a world in which for 200 years capital workers have been providing a constantly larger proportion of productive input and labor workers have been providing a diminishing proportion of the productive input,(2) economic autonomy, and consequently economic democracy, cannot be achieved without institutions and laws that give effective access to credit to buy capital to an ever-greater proportion of the population. All laws and institutions that impede or prevent achieving economic democracy abridge both the rights of individual citizens to political democracy and to economic democracy; they transgress individual rights to life, liberty, and equal protection of the laws.

2. Permitting the secret government — the cult of one-factor economists — to preempt the attention, energy, resources, and even to spill the blood of our people in "full employment wars," by distracting the society and its most politically active people into alleviating the effects of poverty rather than its cause, does not fulfill the Congressional duty, or the duty of citizens, to seek and find economic democracy as a component of each citizen's total of democratic power. The accomplishment of that task through Social Capitalism will be astonishingly simple when compared to the stonewall impossibility of achieving democratic goals through redistributing — as labor workers' incomes and as welfare — the income largely and increasingly produced by oligarchically owned capital.

3. The deceptive questions of the one-factor economists should be dismissed from the national economic debate, and replaced with rational questions capable of leading to right answers:

a. We should ask "why are people poor?," rather than "how can we alleviate the effects of poverty?" The right question almost instantly evokes the right answer. People are poor because they don't own enough capital.

b. We must stop asking "how can we redistribute more income to the

(1) See illustration, Page 2.

(2) See illustration, Page 41.

poor in order to enable them to enjoy the benefits of science and technology?" and ask "how can we phase out poverty and redistribution of every variety and achieve economic autonomy?" The right question leads to the answer of Social Capitalism; a capitalist economy that works for every citizen, not just for rich citizens. After two centuries of business financing built upon the Divine Right of Kings — American Style, the Employee Stock Ownership Plan (ESOP) was literally introduced to Congress in 1973 by a "Dear Colleague" letter from the Chairman of this Committee, the Honorable Mark Hatfield, working in collaboration with Senator Russell Long, then Chairman of the Senate Finance Committee. That letter, dated November 5, 1973, set forth the first and to date the only significantly implemented technique of corporate finance that conforms to our constitutional mandates of the right of every citizen to life, liberty, and equal protection of the laws, and the right not to be deprived through technology of his productiveness as a labor worker without the opportunity to become even more productive as a capital worker. The outcry of the one-factor economists to the ESOP provisions of the Penn Central financing legislation was predictably unanimous: "Capital theory is nonsense" and "even if it is logical, it won't work," etc. They effectively vetoed the Congressional enactment.

Because Congress did not suspect the collaboration between the self-interest of the one-factor economists and the barons of morbid capital, it failed to adopt measures to prevent them from fraudulently frustrating the intent of the Penn Central bill, that government funding of the rail reorganization be loaned to the new corporation through an ESOP covering all employees. The result has been an economic disaster. Annually, additional billions of dollars have been appropriated to keep Amtrak alive. Featherbedding has continued. The stock and bond holders of the bankrupt railroad made off with the corporate shell, the tax loss carry forwards, and sufficient assets to again put the corporation almost overnight among the leaders of the Fortune 500.

Because the one-factor economists naturally wish to preserve their decades-old control of the American economy and to save their faces and their multi-billions of dollars of income and perquisites, they monitor the faculties and publications of every business school, every law school, the economics, political science and philosophy departments of every university, and the educational institutions operated by every professional and trade association in the country. They use their status as "experts" to censor Social Capitalist thought from all publications dealing with or even touching upon economic matters, thus effectively keeping Americans in ignorance of the Social Capitalist alternative and perpetuating the one-factor fraud.

c. I alluded earlier to the fact that one-factor economics only knows one proven way to terminate a depression: war preparation. In view of this, the "full employment" potential of war through our current military build-up toward global suicide is not without significance. The only way to significantly increase labor employment and magnify the morbid capital of the owners of munitions plants, in the face of a diminishing demand for consumer goods and services produced by labor, is to produce goods and services that do not depend upon purchase by consumers spending their own shrinking incomes. Military goods and services sold to taxpayers through deficit financing and taxation are the one-factor economists' answer, notwithstanding the fact that war between the United States and Russia is as obsolete (because it is suicidal) as the dinosaur.

The fact is that Russia is in an impossible posture, and we are making compatiblity even more difficult. Russia cannot yield to the pressures to democratize its institutions (such as those in Poland and Afghanistan) while it is nominally in the ridiculous "dictatorship of the proletariat" phase of socialist development any more than we can democratize the United States or lead any third world country to honest economic development through economic democracy so long as the one-factor economists hold our minds in bondage. Karl Marx, to whom the Russians pay lip service, was passionately looking for the kind of full human freedom for individuals that can be achieved only under Social Capitalism. Until the United States can establish a model polity that is both rational and practical and conforms to the prescriptions of its own Constitution, it cannot be expected to favorably influence the policy or institutions of Russia or of any other nation.

As for U.S. governmental measures aimed at weakening the Russian economy, we would do well to remember the results of similar measures used on Germany after World War I.

Although ideas can be destroyed only by better ideas, the predicament of the cult of one-factor economists is that they see no way to save their faces while permitting a better idea — Social Capitalism — to become national economic policy in the United States. Fortunately, Congress' responsibilities in this matter rest upon the Constitution and not upon the *ex cathedra* myths of a defunct priesthood.

## Can Our National Economic Policy of Full Employment Be Made to Work?

Yes, if we would but make peace with reality and acknowledge that there are two ways in which people can work, i.e., engage in economic production. One is through their privately owned labor power, as labor workers, and the other is through their privately owned capital, as capital workers. Economic autonomy, the natural economic goal of a political democracy, implies that everyone be engaged in producing the standard of living he wishes to enjoy. This is full employment in the two-factor sense of the word and in the sense that J. B. Say intuitively understood. Economic democracy cannot be found where the few produce for the many, for that is the kind of economic imperialism that weakens, trivializes, and enslaves the underproductive majority.(1)

As a practical matter, at our stage of technological development, if the value of labor inputs and capital inputs into the economy were both competitively evaluated, it is quite possible that only a few labor-worker geniuses, like the Beatles, could produce a satisfactory level of income unaided by capital ownership. Thus everyone needs a growing holding of revitalized capital.

## Implementing Social Capitalism — The Eight Financing Tools for Implementing Transition to a Social Capitalist Economy

The basic financing tools to implement capital theory have been designed and their logic has been tested operationally over a 25 year period, because each implementing tool is constructed on the logic embodied in a properly-designed ESOP. This logic testing has been accomplished under extremely adverse — actually hostile — environmental conditions; conditions that Social Capitalism would eliminate. The eight implementing tools are:

ESOP: Employee Stock Ownership Plan. The ESOP is designed to build capital ownership into employees of a business in the course of efficiently financing its growth or other desirable corporate objectives, without deductions from paychecks or invasion of savings of employees. As to employees, the ESOP is that constitutionally-mandated missing link that gives them access to credit to buy the employer's capital stock and,

(1) See the quotation from Mills' *On Liberty*, Page 38.

without personal risk or liability, to pay for it from the pre-tax earnings of the assets underlying that stock; in other words, equalizing their access to capital credit with the already rich. Estimates place the number of operating ESOPs at more than 5,000.

MUSOC: Mutual Stock Ownership Corporation. This financing method is intended to provide pooled ESOP financing for a number of corporations while building diversified portfolios in their stocks individually into the employees of each.

CSOC: Consumer Stock Ownership Corporation. This technique is intended for use in public utilities, banks, insurance companies, and other businesses where long-term relationships between a producer and its customers are the rule. It builds capital ownership into customers while providing unlimited low cost financing for growth of the corporation, thus raising the power of the consumers to pay for their purchases of goods and services while raising the power of the corporation to produce goods and services. It would normally be used in conjunction with an ESOP for employees.

GSOC: General Stock Ownership Corporation. Designed to build capital ownership into politically designated classes of consumers within the jurisdiction of the authorizing government — state, local, or federal. While it is in need of several amendments, a GSOC law was enacted in 1978 as Subchapter U of the Internal Revenue Code.

ICOP: Individual Capital Ownership Plan. A financing device intended to create viable capital estates individually in governmentally selected categories of qualifying individuals while opening broad markets for equity financings by corporations.

RECOP: Residential Capital Ownership Plan. This financing plan, in combination with pure credit financing, would enable home buyers to purchase homes at less than 25 percent of the out-of-pocket principal and interest cost of a similar transaction today by having their acquisitions treated by tax and other relevant laws as capital assets, rather than as consumer items as at present.

COMCOP: Commercial Capital Ownership Plan. Ownership of rental structures, such as office and apartment buildings, factories, mines, railroads, hotels, resorts, etc., is a major source of investment income. Today such structures and real estate generally are owned by the excessively wealthy (whose resulting income is thereby sterilized for purposes of the consumer economy), who use such acquisitions not only to satisfy their anti-social greed, but to wipe out their income taxes. COMCOP would enable commercial structure ownership legitimately to be spread over large numbers of people where it can raise their power to produce the incomes they need to make them powerful and self-supporting consumers, satisfy their lifestyles, and diversify their holdings in businesses in which they become employed as capital workers.

PUBCOP: Public Capital Ownership Plan. This plan is designed to provide low-cost financing for capital instruments used by public bodies of all types — office buildings, streets and sidewalks, parks, street lighting, schools, universities, subways, waterworks, harbors, etc. It permits broad individual ownership, through facilities corporations, by great numbers of people, while providing capital facilities to be leased at market rates to cities and other municipal corporations, states, the Federal government, and other public bodies. PUBCOP is another tool in the arsenal of Social Capitalism to assure that each individual can become employed as a capital worker and that governments do not acquire economic power that should be owned in reasonably-sized holdings by citizens. PUBCOP financing would employ the dual functions of other capital financing devices and would be a major means of eliminating the cost of wasteful, inefficient, and inadequate public employee pensions, while providing much greater economic security to public employees and others.

### Pure Credit for Capital Financing

This is a rational method of providing money for capital acquisitions by using more intensively and logically the feasibility principle of traditional finance, while substituting a form of commercial risk insurance for our currently unconstitutional but dominant collateral risk insurance. Such a financing source is necessary to accomplish the transition from our pre-capitalist economy to a Social Capitalist economy and to enable the economy to operate thereafter at full power. Not only would this dispense with the crippling mythology of the one-factor economists that high interest (a major cause of inflation) is necessary to control inflation, but it would enable us to restore the integrity of private property to the ownership of capital. The broadening of capital ownership will not bring about economic democracy unless the full wages of capital are paid regularly and fully to the owners of capital. Pure credit not only makes this possible, but it restores integrity and usefulness to Say's Law. Supply can create its own demand if our business and financial institutions are operated so as to substantially eliminate morbid capital and match the unsatisfied needs and wants of individuals to increases in their productive power.

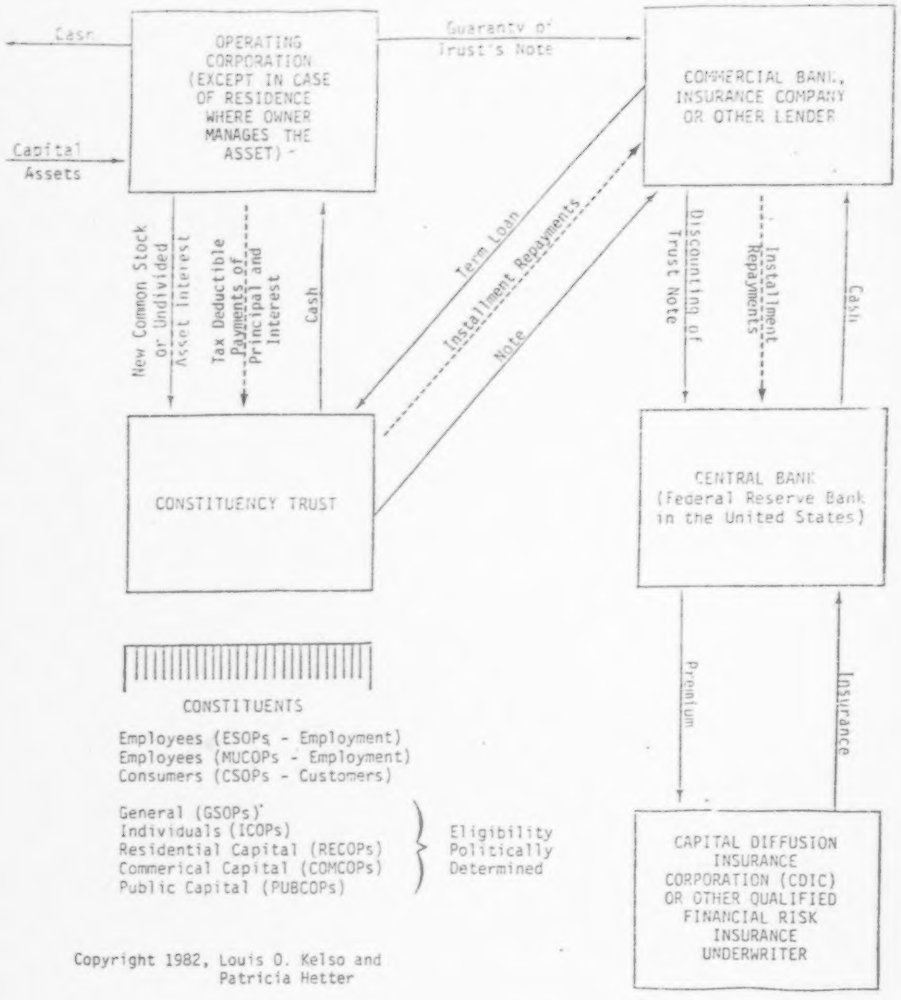
## Social Capitalist Financing and the Business Cycle

The economic needs and wants of civilized people do not fluctuate, but gradually rise and then stabilize at a point that supports their lifestyles. The power of a resource-rich and trading-competent economy like that of the United States to produce goods and services does not fluctuate, but rises steadily and indefinitely towards a theoretical state which we might identify as "solid-state affluence." Thus it is clear that business cycles are man-made; the result of avoidable mistakes, not natural phenomena as the one-factor economists would have us believe.

Consequently, by insuring the risk of non-feasibility through casualty insurance techniques, we would not only end the cause of future accumulations of morbid capital and achieve a logical and workable economy, but we would make the use of capital financing tools easy and effective. Granted that from the historic experience with FHA Housing Insurance, Federal Deposit Insurance Corporation insurance, and other similar applications of the casualty insurance principle, the Capital Diffusion Insurance Corporation probably should be initially established as a government corporation. But this precedent should soon be imitated by private underwriters, just as in the case of MGIC insurance which was organized to compete, and does successfully compete, with FHA. This should be one of the greatest untapped insurance product markets ever. Indeed, most life insurance itself is justifiable only on the basis of the soundness of one-factor economics, another reason why we have resistance to two-factor theory. Financial feasibility insurance in transactions involving the use of pure credit will prove to be both easy and inexpensive from the standpoint of the borrower, and very profitable for the seller. My estimate is that the average premium eventually will not exceed one-quarter of one percent per year.

The following diagram shows how, in general, pure credit and commercial feasibility risk insurance would function in connection with use of any of the eight implementing tools designed to effect transition to a Social Capitalist economy, and to finance the operations of the economy thereafter.

GENERAL THEORY OF CAPITALIST FINANCING


Cash
OPERATING CORPORATION (EXCEPT IN CASE OF RESIDENCE WHERE OWNER MANAGES THE ASSET)
Capital Assets
Guaranty of Trust's Note
COMMERCIAL BANK, INSURANCE COMPANY OR OTHER LENDER
New Common Stock or Undivided Asset Interest
Tax Deductible Payments of Principal and Interest
Cash
Term Loan
Installment Repayments
Note
Discounting of Trust Note
Installment Repayments
Cash
CONSTITUENCY TRUST
CENTRAL BANK (Federal Reserve Bank in the United States)
Premium
Insurance
CAPITAL DIFFUSION INSURANCE CORPORATION (CDIC) OR OTHER QUALIFIED FINANCIAL RISK INSURANCE UNDERWRITER

CONSTITUENTS

Employees (ESOPs - Employment)
Employees (MUCOPs - Employment)
Consumers (CSOPs - Customers)

| | |
|---|---|
| General (GSOPs)<br>Individuals (ICOPs)<br>Residential Capital (RECOPs)<br>Commerical Capital (COMCOPs)<br>Public Capital (PUBCOPs) | } Eligibility Politically Determined |

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Patricia Hetter

Summary

Social Capitalism, and the right of each citizen to life, liberty, and equal protection of the laws under the United States Constitution, require:

a. Adoption of a Social Capitalist national economic policy to enable those who are not already capital workers to become capital workers by means using the logic underlying the ESOP. The ESOP and the seven other financing techniques blueprinted in Social Capitalism are simultaneously capable of (1) financing every type of capital requirement of commerce, industry, and government (except military goods which in their nature are not producer goods and do not pay for themselves), and in the same transactions and with the same dollars, (2) making millions upon millions of new capital workers. These steps, together with (3) the hardening of the laws of property so that capital workers collect the full wages of their capital, and (4) general availability of low-cost pure credit for financing individual capital acquisition, will put the economy on a sustained upward growth curve. These steps will not only fulfill the constitutional right of every citizen to economic as well as political democracy, but will raise the income-earning power of individuals who need and want to consume more goods and services, rather than merely the incomes of those who can only use more income to acquire more excess sterile productive power, i.e., more morbid capital.

b. A national economic policy based on capital theory requires legislatively implementing the use of pure credit. The simple mechanics of pure credit were first described in 1961 in The New Capitalists by Kelso and Adler. Pure credit was again explained in a 1974 paper prepared for President Gerald Ford's Inflation Summit Meeting, entitled "A New Economic Policy to Meet the Needs of the American People and of the U.S. Economy." The effective interest cost to the borrowers of such capital-financing credit, where Congress authorizes its use, should not exceed two percent, and aggregate credit availability would be limited only by the economic feasibility of the asset growth thus financed.(1) Neither the

(1) In the 1974 paper for the Economic Summit Meeting on Inflation, and in earlier writings, out of an excess of caution we suggested confining the use of pure credit financing to new capital formation. Clearly that is an unncessary precaution given the monumental problems of broadening capital ownership and accelerating the rate of economic growth. Every capital acquisition by well managed businesses, whether of newly-formed capital or not, must pass feasibility tests.

Federal government's credit, nor its accounting, nor government guarantees would be involved. Pure credit links growth of the economic power to produce with growth of the power to consume of those with unsatisifed needs and wants by enabling them to become capital workers.

c. Pure credit can be used selectively at first, as for financing ESOPs, or for the housing industry, or effecting the sale of the twenty-two operating telephone subsidiaries to be divested by AT&T to their consumers (through Consumer Stock Ownership Plan (CSOP) financing) and to their employees through ESOPs.

## Oligarchic Savings vs. Democratic Savings

Functionally, of course, all producer goods (real capital) and cash or liquid assets that can be readily converted into producer goods are "savings." The important distinction, however, for purposes of understanding capital theory and the use of pure credit, is the distinction between oligarchic savings and democratic savings.

Oligarchic savings are real capital (or liquid assets that can be readily converted into real capital) that produces for its owner income he cannot, because of his own physical or moral or intellectual restraints, use to support his consumer lifestyle. In other words, oligarchic savings are morbid capital.

Democratic savings are savings (capital) that are fully used by the owner to provide income for consumption and enjoyment for himself and his dependents.

Democratic savings are healthy. Oligarchic savings are the biological equivalent of cancer: a thing that grows relentlessly out of symbiotic relation to the organism to which it is attached.

The 193-year reign of economic oligarchy in the United States will begin to disappear as quickly as the tools for implementing Social Capitalism and the use of pure credit are legislatively authorized.

## Money and Banking Under Economic Democracy

Modern banking systems are built primarily on the idea that capital transactions can be financed only through the use of accumulated savings or morbid capital. This idea is the very heart of the Divine Right of Kings — American Style. Used in parallel with this false idea is the associated belief that life, liberty, and equal protection of the laws under the American Constitution can be satisfied through equal opportunity (and equal liability, as the Marxists openly, and we covertly, insist) of all who do not own capital to toil. Democratic enlightenment, on the other hand, holds that each citizen has a right and duty to support himself and his dependents through participation in production as a labor worker, or as a capital worker, or both. Fortunately, the economy of the United States and its existing institutions can operate far more efficiently and smoothly under a Social Capitalist economic policy than under a one-factor economic policy. The use of morbid capital savings that frustrate almost every healthy aspect of the economy would end in time as capital ownership begins to grow where it is useful and needed rather than where it injures the public interest. We have the institutions necessary to make a Social Capitalist economy work; the parts are in place. We need merely correct their present misuse.

Pure credit is implemented through contractual relationships, often a complicated web of contracts, amounting in effect to a refined and rationalized barter system. It involves in each contractual web the owners, sellers, or builders of capital goods, the buyers and users of capital goods, and the labor workers and capital workers who produce capital goods and consumer goods and services. Each individual who participates in production as a labor worker, a capital worker, or in both capacities, contributes goods and services (productive inputs) into the economy in exchange for equal value, competitively determined and measured in money units, of other goods and services produced by others. Under primitive barter, goods and services themselves are exchanged, and so an in-kind barter system can only be used in the simplest of economies. The use of money changes the form of barter from goods and services in return for goods and services to goods and services in return for money and then again through money to goods and services. In toto, the process of sophisticated barter can be described as individual production of goods and services which translates into → money, which in turn translates into → individual use of money to purchase goods and services for consumption.

## Conclusion

Only Congress can rescue the economy of the United States from a potentially fatal depression, and from creating a one-factor full-employment war that would suspend civilization for several hundred thousand years. Only Congress can rescue the American society from hypocrisy, from its retreat from greatness, and from its failure to fulfill its promise to the world and to the American people to maintain the torch of democracy — political democracy foundationed upon economic democracy.

Miraculously, we have within our grasp all the ingredients, including, very importantly, the institutional infrastructure. We need only courageous legislators to initiate the change, a courageous judiciary, and a clear-eyed executive to complete the task.

Abraham Lincoln said that the purpose of government is to do for the people what they cannot do for themselves. The task I here urge upon Congress — the adoption of a national economic policy of Social Capitalism and the adoption of legislation to implement that policy, accompanied by the thoughtful analysis and debate that is required to minimize error — is, I am certain, the kind of task that Mr. Lincoln had in mind.

In the words John Stuart Mill used to conclude his Essay On Liberty:

> "A government cannot have too much of the kind of activity which does not impede, but aids and stimulates, individual exertion and development. The mischief begins when, instead of calling forth the activity and power of individuals and bodies, it substitutes its own activity for theirs; when, instead of informing, advising, and, upon occasion, denouncing, it makes them work in fetters, or bids them stand aside and does their work instead of them. The worth of a State, in the long run, is the worth of the individuals composing it; . . . a State which dwarfs its men, in order that they may be more docile instruments in its hands even for beneficial purposes — will find that with small men no great thing can really be accomplished; and that the perfection of machinery to which it has sacrificed everything will in the end avail it nothing, for want of the vital power which, in order that the machine might work more smoothly, it has preferred to banish.

Respectfully submitted,

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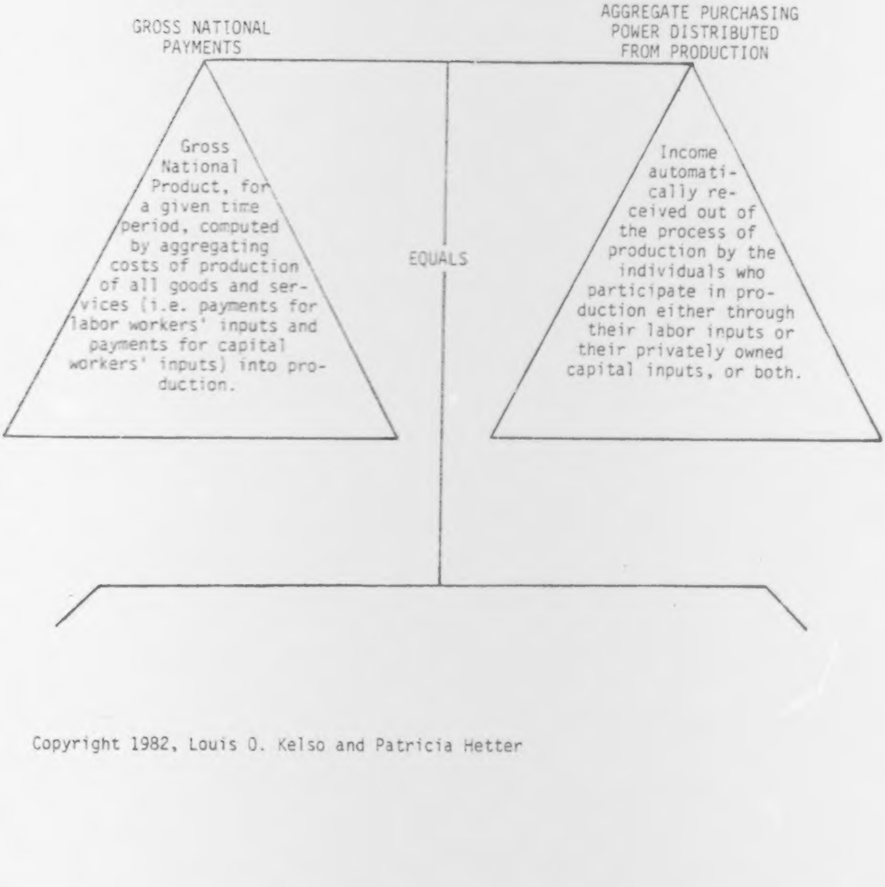
## SAY'S LAW

In A Market Economy the Market Value of Good's And Services
Produced During A Given Time Period Is Equal to the Income
Distributed to the Participants In Production.
Say's Law Is Simply A Prose Statement of the Principle
of Double-entry Bookkeeping And of Barter, the
Logic of A Private Property, Market Economy.


GROSS NATIONAL PAYMENTS
AGGREGATE PURCHASING POWER DISTRIBUTED FROM PRODUCTION
Gross National Product, for a given time period, computed by aggregating costs of production of all goods and services (i.e. payments for labor workers' inputs and payments for capital workers' inputs) into production.
EQUALS
Income automatically received out of the process of production by the individuals who participate in production either through their labor inputs or their privately owned capital inputs, or both.

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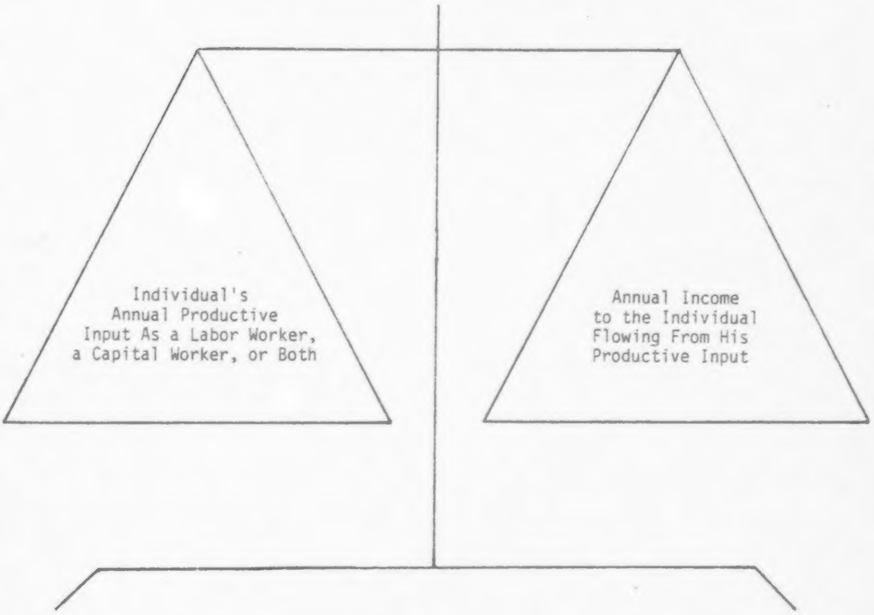
# THE LOGIC OF ECONOMIC DEMOCRACY

## SAY'S LAW AS APPLIED TO INDIVIDUALS

Distribution of individual annual income in a market economy is based upon the individual's annual productive input into the economy as a labor worker, a capital worker, or both.


Individual's Annual Productive Input As a Labor Worker, a Capital Worker, or Both
Annual Income to the Individual Flowing From His Productive Input

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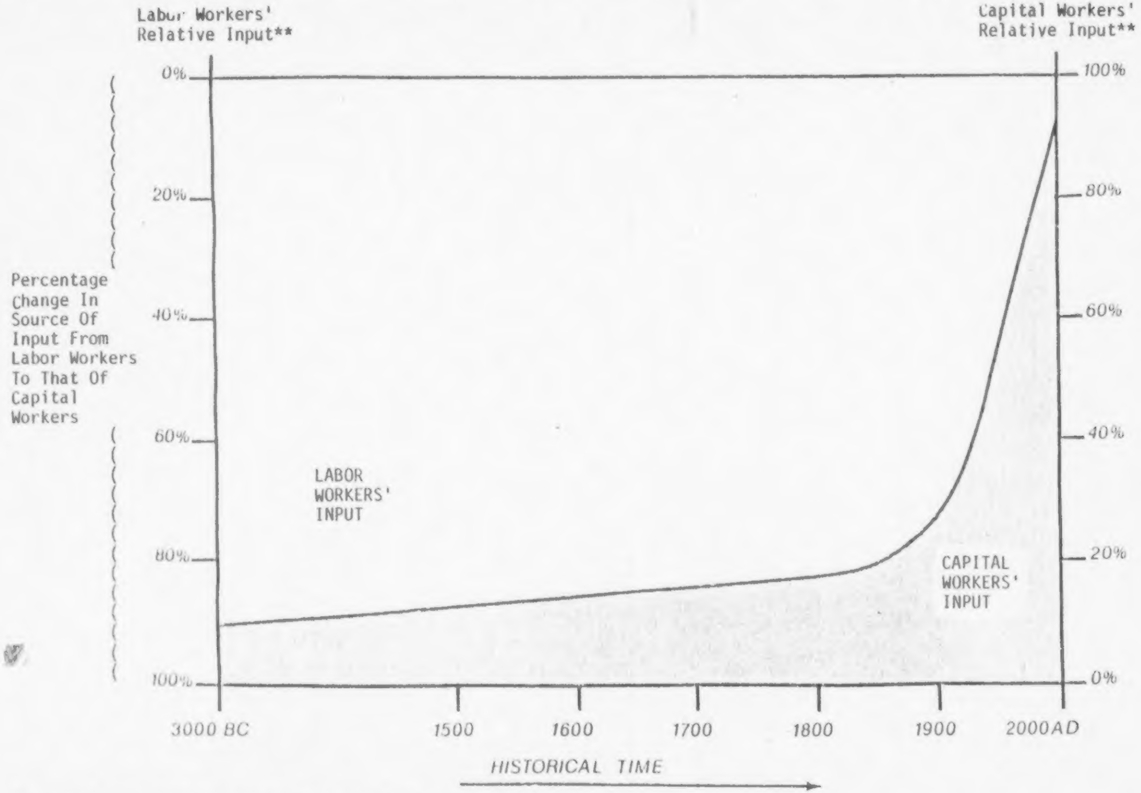
## THROUGH TECHNOLOGY, CAPITAL PRODUCERS DISPLACE LABOR PRODUCERS -- BUT ESOPs MAKE LABOR PRODUCERS CAPITAL PRODUCERS TOO*



* From SOCIAL CAPITALISM: WHO SHOULD PRODUCE THE WEALTH OF NATIONS?

** Estimated on the assumption that the value of each type of productive input is determined in reasonably competitive markets.

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## INTRODUCTION OF DR. KELSO

Chairman HATFIELD. Dr. Kelso, we are delighted to have you here. I might say that I have had the privilege of knowing you and your wife for some time now, and find your ideas and your economic theories not only to be revolutionary in concept, exciting, but where they are tried and adopted have been very successful, particularly the ESOP program. I am very pleased to have you before our committee this morning.

Mr. KELSO. Mr. Chairman, gentlemen, it is a great pleasure to be here. I wish to submit my oral testimony under the same copyright claim as my written testimony, with the same license to the committee to reproduce it in the committee's usual hearings reports.

What I have to say this morning will not fill you with joy as to our economic prospects; Dr. Volcker did that. At least I think he made you feel better about the way things are than I am going to do.

## THE DEFECTIVE U.S. ECONOMIC POLICY

I believe that the economic policy which has dominated the United States for the past 50 years contains a basic defect, and that because of that defect we are in the early stages of a massive depression that will make the 1929 to 1940 depression look tame by comparison.

It lies within our power to correct that policy. I say "our" power because I think it can only be done in Congress; the change cannot be made within the banking system, and it certainly cannot be done in the stock markets.

The policy of "full employment," our national economic policy, that asserts we will basically solve our income distribution problems through full employment of labor workers, is manifestly and obviously wrong unless we recognize that there are two kinds of workers, one of which is totally left out of the policy.

## LABOR WORKERS/CAPITAL WORKERS

There are labor workers, of course; there always have been. But there are also capital workers. Labor workers work through the powers of their body. Capital workers work through their privately owned capital. The relative inputs from these two types of producers change with technological advance.

To see the impact of technology to which I refer, Senator, please turn to the last page of my written testimony. You will see there a diagram that illustrates roughly what has been going on as the result of technological change over a 5,000-year period. In the upper part of the diagram represents labor workers' input into the economy; the lower part, capital workers' input into the economy. I think it is an extraordinary coincidence—it must have more significance than we can presently understand—that historians date the beginning of the industrial revolution to coincide with the beginning of the American Revolution—in 1776.

If this diagram is at all respresentative of the periods covered, and I believe it is, today we are at a point in our history where the input of capital workers is far greater than the input of labor workers, if the values of both inputs are determined through workable competition.

### J. B. SAY'S LAW

I would like now to turn to the preceding two diagrams, one of which relates to the overall economy, and the other to an individual producer-consumer. These diagrams express what economists call "Say's law." J. B. Say was a mercantile economist, a contemporary of Adam Smith, and the man who really discovered, or perhaps we should say co-discovered the logic of a market economy.

Say's law is one of the most hotly disputed ideas in economics. It has never been refuted rhetorically. Lord Keynes was alleged to have done so, but he scoffed at the accusation. One cannot dispute an identity, he observed.

Anyway, the diagram on page 39, applying Say's law to the gross national product, shows it to be exactly equal to the income automatically distributed through the process of production to the participants in production. From this, J. B. Say concluded that in a market economy, if the Government kept its hands off, you couldn't have a depression; you wouldn't have ups and downs, things would go along smoothly. Whatever was produced would be currently consumed. Supply, he said, creates its own demand because production generates the purchasing power to enable consumers to buy what is produced.

The diagram at page 40 represents the same idea applied to an individual producer-consumer. The individual through receipt of the market value of his inputs during the year as a labor worker, or as a capital worker, or as both, receives consumer purchasing power, when measured by market forces, equal to the value he added to the product. The same market forces that measure the value of what he produced during the period simultaneously measure the income he receives as a labor worker, or as a capital worker, or as both, and the two are necessarily equal.

This is logic of the market economy. It is simple and straightforward. While it has never been refuted on paper, it has never worked in the real world—for an obvious and good reason which, perversely, economists refuse to see. It is that we count producers as only labor workers; we do not count capital workers as producers in the same senses that labor workers are.

Before the exponentially rising impact of technological change made itself known, about the time of our Revolutionary War—see the final diagram in my written testimony—the failure to understand that capital workers are economic producers in the same senses as labor workers was not yet disasterous. We could tolerate a handful of families owning all the capital in the early stages of industrialization. But today, as the stresses within our economy demonstrate, we can no longer pretend that capital workers are not just as real as labor workers.

### WORKER "PRODUCTIVITY"

Let me see if I can emphasize why Say's law, properly understood, is so critically important. We pretend, day in and day out, that we can change the productiveness—notice I did not say the "productivity"—of mature workers. But the facts are that we cannot. Once a worker is mature in his job, he is trained, he has picked up the experience he needs to do that job well, there is absolutely nowhere his productiveness can go but continue at the same level, or decline. The best he can normally do is to stay on the same level of productiveness for 25 to 35 years. He may, with dililgence. move up to a more demanding and better paid job, and another worker takes his place.

In other words, Congress has no power to carry out the national economic policy because it cannot make labor workers more productive in the teeth of technological change which favorably affects only the productiveness of capital owned by capital workers. Sooner or later, this diminshes the demand for labor workers, thereby reducing their market-determined incomes.

Technology is a fact of life. It is not an economist's smoke screen.

Now, you can, however, examine the world of finance and see why all of the capital-productive power is owned by a tiny stationary base consisting of about 5 percent of American families; why there are so few capital workers in spite of the vast accumulations of capital. This condition results from two fundamental principales that dominate the world of finance. Finance is that part of the business world where decisions concerning new capital formation and changes in the ownership of existing capital assets are made.

### FEASIBILITY IN THE LOGIC OF FINANCE

The first principle of finance is the logic of feasibility. This is the ancient logic of capital formation and capital acquisition, causing an intelligent buyer not to acquire ownership of a capital asset that won't, in the buyer's best judgment, pay for itself in a reasonably short period of years. The rule of thumb is 3 to 5 years.

### COLLATERALIZATION

There is, however, a safety factor added to the feasibility requirement—a "policy" of casualty insurance, if you will. The type of insurance that is rigidly and traditionally used for this purpose however, is self-insurance. It is called "collateralization."

Collaterization means, in the finance world, that a potential buyer of a capital asset cannot have access to credit to make the purchase unless the buyer is already sufficiently rich to self insure against nonfeasibility. The amount of such "insurance" or collateral varies with the circumstances and with the lender. A rule of thumb is 25 to 35 percent of the amount of the credit sought. The effect of this artificial method of insuring feasibility, however, is to limit access to credit to buy capital to the already rich!

Now, think of what I have just said. I have said that there are two factors of production, not one, and thus two ways to earn a living, but that we do not treat capital as a factor of production. Thus, we do not treat the capital owner as a capital worker, as one who "works" and earns vicariously. Yet that is what technology is all about; it is supposed to spare some of the burden of toil. It is treated rather mystically, as a catalyst that somehow or other raises the productiveness of the worker, who doesn't own it.

The fact of the matter is that it does not raise the productiveness of the worker, who doesn't own it. What it does do is to raise the productiveness of the combination of the two, because capital workers participate in production in the same senses that labor workers do. By subtracting the wages of labor and all other production costs from gross income, you quite quickly arrive at the wages of capital, a residue we call "profits."

### WORKERS' ACCESS TO CAPITAL

But in a private property world in which one is supposed to get the value of one's productive input, the products of one's labor belong to the worker, and in precisely the same sense, the products of one's capital should and do belong to the capital owner. But because we have an economic policy and practice in the business world that makes access to capital depend upon the prior ownership of capital, you have what Patricia Hetter Kelso and I call the "divine right of kings—American style." That is to say, those who have capital have exclusive access to credit to get more capital. Those who do not own capital have no access to capital credit at all! The capital owners, relatively speaking, don't need more capital, while the noncapital owners, because technology relentlessly erodes their economic value as labor workers, are required by Say's law to become capital workers as well if they want to be economically self-sufficient in an economy where capital workers are the major factor of production.

### ECONOMIC SIGNIFICANCE OF CONSTITUTIONAL RIGHTS

Aside from its massive and critical importance to understanding a market economy and how it works, whether we acknowledge them to exist or not, the fact of the existence of capital workers has grave implications under our Constitution. The existence of capital workers, and their functional importance, also has grave implications for Congress under the Constitution. That Constitution, as you all know, assures, beginning with the Declaration of Independence, the rights to life, liberty, equal protection of the laws, and the right not to be deprived of one's property without due process of law. The right to life has economic signifiicance; it is not merely the right to biological existence on creature comforts purchased out of the earnings of others. It includes the right to support yourself under free market conditions; the right to produce the income equivalent of what you want to consume.

Democracy consists of institutions public and private that allocate to each citizen two forms of power. We customarily think of it in terms of only one; and that is not enough; it won't work. It is not working.

Economic power is as critical to democracy as political power. One without the other is a form of weakness, *not democratic power diffusion*. The function of democracy is to provide an arrangement of power within a world that is built and operates to the human scale, the scale of the individual human being, but with political power devoid of economic power, the individual is little better than a serf or a social parasite who has the right to express his opinion at elections.

### AVAILABILITY OF CAPITAL TO POOR

The President said the other day, in defense of his budgetary program, that he should not be criticized as not paying attention to the poor, since we are providing 98 million—I think was the number—of subsidized meals everyday and billions of social security and other forms of welfare payments. The right to life is not the right to live as a parasite. I am as certain of that as I am of tomorrow's sunrise. The right to life consists of the right to produce what you want to consume as well as to democratically participate in the exercise of political power. I believe it is the duty of Congress under the Constitution to make access to capital credit available to the 95 percent of citizens who, because they own no capital, or insufficient capital, are economically underpowered. They cannot produce for themselves as labor workers only, the income required to enable them to earn a reasonable living. Making this change is an easy thing to do, once we concur that it must be done. My written testimony, which I am assured will be included in the record, covers the highlights of implementing a social capitalist economic policy.

### THE NATIONAL ECONOMIC POLICY SHOULD ADOPT A GOAL OF ECONOMIC AUTONOMY

If Say's law, as I have interpreted it, is sound, and everything that I have to say about economics is based on the soundness of that law, then it means that the purpose of production in a political and economic democracy is consumption. Not just consumption by someone, but consumption by the producer and his dependents. Economic autonomy is economic democracy.

What about the economic arrangement that permits a single family to accumulate the productive power that would support the self-chosen consumer lifestyles of 10 people; 10 families; 100 families; 1,000 families; 100,000 families? Is that economic democracy? No; it certainly is not.

What has taken place is that because we do not understand that there are two ways for individuals to earn income, capital ownership tends to become more and more concentrated. The ownership of capital in the United States, by every study that has ever been made shows that virtually all of it is in the top 5 percent of the wealth holders. It is not owned by those with unsatisifed needs and wants but for the most part by people whose needs and wants are satisfied out of a small fraction of their productive power. It is perfectly clear then that if U.S. citizens are to be protected in their rights to life, liberty, due process, and equal protection of the laws, we must make the institutional changes that, by permitting legitimate broadening of capital ownership, will enable us to use the logic of Say's law.

The budgetary problems of Congress today are problems of redistribution of wealth and income that arise from our failures in the past to structure economic democracy into our economy. Eighty-five percent of our Federal budget, I estimate, relates primarily to redistribution of wealth and income.

Without solving the income problems of the man who cannot earn the income he needs to support a reasonably self-chosen lifestyle for himself and his dependents, we are forced to use Government to redistribute income. And the economic pains we are going through are the result of that redistribution. We futilely and incessantly try to break one of Aesop's most basic laws: To you can give meat to a tiger, but you can't take it away from him. There is no way out of our present economic mess other than through changing our economic policy to one based upon the principles of social capitalism, and then implementing that policy.

### 1937 INVESTIGATION OF AMERICAN ECONOMY

Back in 1937, Franklin Roosevelt persuaded Congress to convene the Temporary National Economic Committee. The committee conducted the most exhaustive investigation of the American economy that has ever been conducted of any economy, and at the end of that investigation in 1941, Senator Joseph O'Mahoney, the chairman, filed the final report of the committee. The purpose of the investigation was to answer the question, "What caused the Great Depression?" Why did it happen? The committee's answer was: We don't know. We know what ended the Depression, but we don't know what caused it. What ended it was spending to prepare for war.

Fifty years later in a 50th anniversary issue—commemorating the 50th anniversary of Business Week, as well as that of the Great Depression, Business Week, with its great panel of economists at McGraw Hill, looked at the question again and said: We still don't know what caused the Great Depression. We just know that World War II ended it.

I don't think gentlemen, that we can listen to advice that we are not in a depression today and close our eyes to the realities that I have pointed out here.

I don't think the economic high priests of our day have any idea of what is going on. There was no reference in Mr. Volcker's testimony, for example, to the people who are suffering, the unemployed, the hungry, and who are going to continue to suffer until they can produce what they want to consume. I like to use the home-building industry as an example, Mr. Chairman, because your State of Oregon is one of the great, in fact the largest, producers of building materials in the United States. Why is it we cannot build but a tiny fraction of the needed homes, good homes, not ticky-tacky boxes? This is a condition which we have been increasingly suffering from for 20 years? Why can't we build good houses when we have all the raw materials, the manpower, the technological know how, the machinery and equipment, the architects, engineers, the management, and the unsatisfied needs and wants? I have mentioned all of the necessary physical things required to produce housing and the physical consumer demand. Physically we can build them, and we need and want them. The answer is that institutionally we cannot put the pieces together. This, along with countless other examples tell us that the economy would work if we understood it; that the basic economic policy of the United States is simply bottomed on the wrong assumptions.

## CORRECTIONS TO U.S. ECONOMIC POLICY

Four changes are needed to correct our economic policy. We need to revise the Employment Act of 1946 so that it recognizes we do need full employment, but in the sense that every individual and every family should support itself by earning its own living.

Second, it should recognize that there are two ways to work, two ways to produce, and two ways to earn income. One is through one's labor, and the other is through one's capital. The questions of whether a particular reduction process calls for labor workers or capital workers, or both, and in what proportions, are technical, scientific, accounting and labor-management questions. They are not moral questions nor political questions. You produce in the way that the state of the art and the state of competition tell you is the best way to do it. The responsibility of Congress is to make it possible for people to produce through their privately-owned capital when it appears that they cannot produce sufficient income through their labor.

## CAPITAL AND THE LAWS OF PROPERTY

Third, we need to tighten up the laws of property to give significance to the broadening of the ownership of capital. We have had to attenuate property in capital to accommodate the fact that, notwithstanding our advanced technology, only 5 percent of families own significant amounts of capital. The capital owner today, on the average, gets but one-twelfth of the income his capital produces. The rest of private property in capital has been eroded away by holes cut in the property pipelines to solve income redistribution problems. The ancient rules of property are based on the idea that you don't own it unless you get what it produces. We should restore that integrity to property in capital. The income-producing power of capital is 12 times greater than it presently appears to be!

But there are two other principles of private property law that Congress should examine. In the British common law and in the American adaptation of the common law of England, there exist two limitations on the rights of every property owner: He may not use his property in such a way as to injure the person or property of another, and second, he may not use his property in such a way as to injure the public interest or public welfare.

Now, when the few wish, through concentrated capital, to produce for the many, it becomes impossible for the many individually to produce for themselves. We are filling our society with involuntary parasites as the result of this, and it not only does not work, but nobody likes it.

### PURE CREDIT FINANCING

Fourth, we must switch from divine right of kings—American style financing of capital transactions to democratic access to capital credit. This, as I explain more fully in my written testimony, continues, of course, primary reliance in every case upon demonstration of feasibility to support capital-financing credit, but involves switching from collateralization insuring of feasibility to commercial casually risk insuring of feasibility. The massive hidden costs of the present nonsystem, when lifted from our heads, will make us feel like we have been reborn into the Garden of Eden.

### BROADENING OWNERSHIP OF CAPITAL

So, we need to vastly broaden the ownership of capital.

I have designed a set of eight tools to implement an economic policy of social capitalism. The essential logic of each of these implementing tools, which are described in my written testimony, is identical to that employed in the several thousand employee stock ownership plans—ESOP's—already operating in the United States.

By legislatively implementing these financing methods, Congress has the power to make it possible to quickly and effectively broaden the ownership of capital, and to make that ownership significant. At today's little trickle of what comes out of the property pipeline, you have to own perhaps $500,000 or more of capital equities for them to be very significant incomewise. If we restore property integrity to capital, one-twelfth as large a capital holding would provide the same income!

To emphasize the critical importance of enabling tens of millions of labor workers to also become capital workers, and tens of millions of unemployed and unemployable to become capital workers as well, not just because it is their constitutional right to do so, but because the economy will not function properly unless we do, let me explain the problem of morbid capital.

First, we all know, you can't concentrate the ownership of labor productive power. Slavery, at least slavery, based upon the ownership of human beings, has been abolished. But you can concentrate the ownership of capital productive power, ad infinitum.

Theoretically, one man can own the entire capital stock of the world. The fact that capital ownership not only can be concentrated, but that it is in fact, highly concentrated, should move us to inquire as to the income distribution effect of such concentration. When an individual through his labor and his capital produces sufficient income to satisfy his own self-chosen life style, and then continues beyond that, to add to his capital stock, that is, to still further enlarge his own productive power, he begins to acquire what I call "morbid capital."

Why do I call it morbid? Because such excessive capital ownership is exactly like cancer; it is a functioning organism attached to an "owner" and grows without any symbiotic relationship to the person it grows on. A billion dollar capital estate represents income-earning power, even under our attenuated property laws, that would support, if we had caused it to grow in the right places, perhaps 3,000 families with incomes of $50,000 each. If we restored full integrity to capital ownership, so that capital workers collected the full wages of their capital rather than only one-twelfth of them, such broadened capital holdings would yield affluent incomes for at least 36,000 families!

Now, I am a lawyer, I am a believer in the American Constitution; I am devoted to the principal of private property and to free enterprise. Merely to make the economy function well, we cannot take property away from a few, who may own too much of it and redistribute it to the many; certainly not. But I am talking about the theory of capitalism—the theory of social capitalism. With this concept, economics becomes a science. Without it, economics is not a science, it is a branch of witchcraft.

The very existence of nature's own principle of limitation—death without the power to take wealth with us beyond life—tells us that acquiring capital ownership, and becoming a capital worker, has a purpose: to enable us legitimately, and with relatively little effort, to individually earn the income needed to enable us individually to live well. Beyond that, wealth accumulations merely beggar our fellow man.

If excessive productive power, matched with limited needs and wants, becomes recognized for what it is, namely the greedy collection of morbid capital to foul up the workability of the economy, to destroy democracy by destroying the possibility of economic autonomy for 95 percent of consumers, then I say, that without changing our economic policy to conform to capital theory, we have an economy that is going to get worse and worse and to collapse in total depression or total war. I don't believe that it is a coincidence in these hard times when the economy is working horribly, that we are faced with an unprecedented military budget. War production is the only known cure for a depression, and it inevitably, today, leads to national suicide.

Mr. Chairman, that is essentially the highlights.

## ALLEVIATION OF POVERTY

Chairman HATFIELD. Thank you, Dr. Kelso. You have a very provocative statement.

First of all, I am so delighted to have you affirm that Mr. Hoover did not cause the depression and that Mr. Roosevelt's economic policies didn't really pull us out of the depression.

Mr. KELSO. Could I respond to that, Mr. Chairman?

Chairman HATFIELD. Please.

Mr. KELSO. The Roosevelt administration came in with a great and quite exciting challenge and the boldness that we needed, heaven knows. But the New Deal's challenge to society was, "What can we do to alleviate the effects of poverty?" There were milions of people starving. And we came forth, administration after administration, Democrats, Republicans, right down the line, with ingenious, marvelous answers to that question, "What can we do to alleviate the effects of poverty."

For people who didn't have income, we initiated aid to families with dependent children, and food stamps; for people who couldn't pay their doctor bills, we legislated medicare and medicaid; for people who didn't have the income to buy a house, we legislated dozens of kinds of housing subsidies, et cetera, et cetera.

The only problem was that "what can we do to ameliorate the effects of poverty" was the wrong question.

The right question should have been not "what we can do to alleviate the effects of poverty," but "what can we do to alleviate poverty?" "Why are people poor?"

We couldn't have asked that right question very many times without somebody coming up with the simple right answer: People are poor because they don't own enough capital.

### ELIMINATION OF BUSINESS CYCLES UNDER SOCIAL CAPITALISM

Chairman HATFIELD. Do I understand from your presentation and reading some of your material that if we had an operating social capitalist economy, it would free us from the business cycles that we have experienced in the past?

Mr. KELSO. Yes, Mr. Chairman. I think the reality is this. The needs and wants of humans don't go up and down like a yoyo. They gradually rise, with maturity and education, to a point where one picks his life style, except that we have been sold the misbegotten concept that the wealthy should ceaselessly seek more and more productive power, conquering their own poverty thousands of times over so that other people can't conquer theirs once. The need for creature comforts is not a fluctuating thing.

On the other side of the economic equation, the power of a great industrial and trading-competent economy like ours to produce goods and services, does not go up and down like a yoyo either. Power to produce goods and services gradually rises as consumer demand rises.

Now, there may be little ripples, but they will be inperceptible compared to what we have today. An economy that puts vast and excessive productive power in the few, and the unsatisfied needs and wants in the many, and which relies upon redistribution and boondoggle and trickle-down to make this nonsystem work, is fraught with ups and downs, and with strife, and with all kinds of artificial distortions in the quality of life.

### SOCIAL CAPITALISM AND INFLATION

Chairman HATFIELD. Will it free us from inflation as well?

Mr. KELSO. Certainly, sir. Inflation is basically the result of trying to redistribute income to people who don't produce it. Inflation causes us to nometize welfare. The opposite of that, Mr. Chairman, is reflected by the diagram on page 33 of my testimony. This is the essential logic of every one of the capital theory financing tools—it is simply the logic of capital financing itself, namely, you tie all capital transactions into the self-liquidating nature of capital instruments. And you do this whether you are buying existing capital assets, or bringing about new capital formation. This logic is the logic of Say's law, as interpreted through capital theory. It requires using maximum effort, in structuring each capital acquisition so as to raise the economic earning capability of underproductive consumers and to avoid raising the earning power of those already earning sufficient income to support their self-chosen lifestyles.

Chairman HATFIELD. Mr. Kelso, if we adopted the social capitalist economy policy, set up by simultaneously expanding the economic growth and broadening the ownership of capital, from where would all the money come?

Mr. KELSO. Mr. Chairman, a closely related and implicit question is "Where would all the money go?" The monetary policy implicit in capital theory is a monetary policy based on recognition that if the people of a society have all the physical means of producing goods and services that consumers desire to consume, and if each consumer is enabled to produce his share of those goods and services, we have the kind of a contract problem that we regularly solve in business and finance.

### INSURING RISK OF FEASIBILITY

The only change required in financing procedures is in the way we insure the feasibility risk.

Let me translate the question "Where does the money come from?"

Into capital theory terms, it becomes the question of "How are we going to insure feasibility?" The cost of insuring feasibility, as long as it is born ostensibly by the morbid capital of the rich, arbitrarily limits economic growth to the amount of such morbid capital availabe, and causes such growth of productive power to occur where it is not needed, and to not occur where it is needed. Where the cost of feasibility is insured through a casualty insurance mechanism, then the cost of insuring feasible capital transactions is evenly spread proportionately over the economy as a whole, and the premiums for such insurance are closely regulated by experience and competition. The diagram on page 33 illustrates the point. For the enormous hidden costs of the conventional methods of insuring feasibility, see pages 7–9 of my written testimony.

The lender, represented by the box up in the right-hand corner of the diagram, where conventional savings are used, is operating on morbid capital. It has to have access to savings in order to provide financing. It is strictly divine right of kings—American style financing. It is a primitive method. Where the immediate lender can simultaneously discount the loan with the Federal Reserve, you are in effect monetizing the assets which two layers, actually three layers with Fed in the picture, of feasibility experts have examined to confirm that feasibility exists. If it exists, then those capital assets coming into the corporation from the left there, pay for themselves in 3, 4, 5, 6 years—whatever the plan calls for—and as they pay for themselves, the credits are reversed all the way back to the Federal Reserve Bank.

Thereafter, the capital assets, preserved by good maintenance, of course, and by depreciation for cost recovery, and by research and development to maintain productiveness at a competitive level, go on producing indefinitely.

Thus, the exclusive use of morbid capital financing is an evil. The idea that we must go on our hands and knees to the agents of people who are simply warehousing morbid capital they can't use and can't take with them, to ask their permission to run the world in an unworkable way, is utterly ridiculous.

If we make the modest operating changes, in our economy to conform both to our Constitution and to applicable economic law—capital theory, we have, or can create, autonomous economic power for every consumer to satisfy our economy's vast unsatisfied consumer needs and wants. We can, in abiding by constitutional mandates and capital theory, end the accumulating of morbid capital, povety, economic parasitism, inflation and, the full labor—worker military boondoggle employment that leads, with today's technology, to mutual international war suicide with our imagined enemy, Russia. We can even eliminate most of high interest costs inflicted on us by misguided economists and morbid capital owners who fear the inflation they force upon us.

These ideas were first set forth in the "Capitalist Manifesto" which Mortimer Adler and I published in 1958 and in the "New Capitalists," published in 1961. In the latter book, using these concepts, we predicted 21 years ago, with absolute confidence that the United States of America would destroy the integrity of its currency and second that its markets would be taken over by foreigners, not because the foreigners would be right and we wrong, but because with a slower start, they would not be as far along on the road to hell as we would be.

The economic problems of the Japanese, if they do not turn to social capitalism, are going to be 10 times worse than ours, if you can imagine such a thing, but that is not going to help us, because we are not going to have any industry left if we don't wake up now.

## HIGH SAVINGS/LOW INTEREST RATE THEORY

Chairman HATFIELD. We heard voices of many people who advanced the thesis that high savings of individuals and lower interest rates to borrowers can return our economy to prosperity. How do you respond to that thesis?

Mr. KELSO. It is in error, Mr. Chairman, it is absolutely in error.

Take a look at those two diagrams illustrating Say's law on pages 39 and 40 of my written testimony. What you see in them is that if the high savings of rich are used to make up the handful of capital workers who have no unsatisfied needs and wants, still more productive, you are simply forcing more redistribution, more inflation, more parisitism, more military boondoggle and more alienation on the American society. What is needed is an economic policy based on capital theory in order to make the underproductive and nonproductive more productive, and to avoid further accumulations of morbid capital.

High savings are highly praised because a few people have them and they want more. For example, in our last year's revenue act, we gave lavish tax recovery allowances, depreciation allowances, to industry, on the idea this would cause great new capital formation. Well, let's look at the underlying reality. We were saying "let's make the excessively productive rich even more productive, and let's deny the opportunity to become more productive to the poor." My definition of "poor" is anybody who doesn't own a significant holding of capital. That is 95 percent of the American population.

The savings myth is absolutely insane, but it is repeated by so many experts that it is believed to be true. I think, in a way, one of the things that the hearings of your committee, Mr. Chairman, might do is to determine how many people have to hear from innocent victims that the emperor has no clothes before the public actually takes a look and finds out that the emperor is actually undressed.

### STEPS LEADING TO SOCIAL CAPITALISM

Chairman HATFIELD. What steps would you suggest to Congress which would move this country toward social capitalism?

Mr. KELSO. Let me respond this way.

First, I would like to say something about the word "social." The word "social" is normally associated with "socialism" in some way. We picked that name, by the way, because when we tried it on a number of people, we found them saying, "social capitalism? But those words represent conflicting ideas?" Yes; they used to anyway; social capitalism is the capitalism of the many. Capitalism, traditional capitalism, is the capitalism of the few. Social capitalism is democratic, because access to capital ownership is available to all, in terms of everyone beging able to buy it, pay for it out of what it produces, and then own it, as a way of becoming more productive.

I would suggest the examination of two approaches, Mr. Chairman. One would be very basic, and maybe it would be the simpler. There is no precedent for this; the economic policy of a nation, in the basic sense I am urging here, has never been changed before. It would be to amend the Employment Act of 1946 to change the national economic policy to recognize capital workers as well as labor workers, and to recommend in the amended law that Congress, business and finance should make every effort possible to make underproductive consumers more productive and economically autonomous through enabling them to acquire capital ownership. As to the efficacy of any change in national economic policy, I can only say that the Employment Act of 1946, even though the "full labor worker employment policy" had been the ad hoc economic policy from 1932, did have an enormous impact. Unfortunately it was an impact in the wrong direction because it forced us into redistributing income and creating phony jobs.

But changing the unsound present economic policy to a sound one would be an enormously important step.

As an alternative approach, there are before Congress at any moment many opportunities to guide the economy into the path of social capitalism. The use of the ESOP, which is now pretty well-hammered-out technology, suggests many cautious ways in which Congress could assert its constitutional mandate to accord citizens economic democracy, if Congress thinks this is a time for caution.

I have been fighting this battle for 40 years. Capital theory is not taught in any schools; it is not taught in any business school, any law school, any economics department, political science department, philosophy or psychology department of any university. Every publication that is significant to business, politics, or finance has its panel of economists who censor and rule out and effectively prohibit the discussion within its pages of capital theory economics. Congress has many ways to break through this one-factor censorship by the economists.

If we had unlimited time for change, we could simply wait for the one-factor economists to die out. I don't think we have time for that now. The ESOP, if properly understood and used, suggests many opportunities available for its use which Congress could encourage. Right now, I am seeking to get financing for purchase of at least a major interst in the assets and business of Kaiser Steel Corp. for its employees through an ESOP. Congress could, by amendment of our banking laws, make inexpensive pure credit financing available to such projects. Such financing would not involve Government accounts, or Government guarantees, or Government credit in anyway.

Employees themselves who are now in a sense saying—by their wage, salary, and fringe benefit cutbacks—that they, by being denied access to credit to buy capital in the past, have been forced to demand more and more pay for less and less work, but are now willing to consider a new economic approach.

An engineer would say that a component of a system that consumes more and more of the system's energy while contributing less and less to the system's output is a very defective component, or a part of a very defective system.

Of course it is. That is how we destroy our industries. Almost all of them are on the way to extinction under this one-factor economic policy that falsifies the economic facts. They, the employees of Kaiser Steel, could make it possible for the corporation to compete with the Japanese, the Germans, and the Belgians, but they need Congress to give them constitutional access to low-cost credit to close their purchase.

It isn't the only place in the world to start changing U.S. economic policy, but it is an excellent one, and proving pure credit financing there would prove it in a lot of other places as well.

Another appropriate place for Congress to begin reordering the economy along capital theory lines is with the divestiture of the 22 operating subsidiaries from A.T. & T. In light of capital theory, Congress has a profound interest in brining about broad capital ownership, particularly of public utilities. Thus, it would seem that this devestiture provides a timely opportunity to inquire into the merits of alternative ways to restructure the Bell System. It cannot be assumed that the public utility commissions in the 50 States will be primarily concerned with rationalizing the overall national economic policy. Furthermore, capital theory calls for making capital acquisition credit available to all citizens on both constitutional and economic grounds, and Congress can do this because it has power over the Federal Reserve Bank. Almost every public utility in the United States is in financial difficulty. Most of the consumers are distraught over their utility bills. These unhappy experiences stem from the same cause: An utterly obsolete economic policy.

Should not Congress formally inquire into the possibility of restructuring the Bell System now so that it becomes an income source for millions of new capital worker consumers of tomorrow? It could become a model for structuring and financing public utilities in the future.

Chairman HATFIELD. Well, Dr. Kelso, I am always intrigued by your observations and your innovative ideas.

I am very grateful you came this morning to the hearing. The record will be widely distributed and hopefully through your appearance there will be a greater understanding of your ideas and perhaps more support.

I am personally very intrigued and looking forward to Miss Hetter's and your publication.

I hope there is some way to inexpensively bind the publication for a wide distribution.

I couldn't help but feel that you put your finqer on one of the key problems in this society. Through public policy we have created great disincentives obstacles, and inhibitions to the productiveness of people, thus creating the impossibility to extracate ourselves from this economic dillema.

I also recall the admonition given by Thomas Jefferson when he spoke on the question of the democratic experiment, then underway, that we must maintain not only a diffusion of political power, but we must also maintain a diffusion of economic power. He coupled those two very closely and I agree.

Many of my brethern in politics today decry the concentration, centralization of political power in Washington. It is interesting that much of the great cry comes fron what is called the conservative wing of the political parties.

Yet that same very conservative wing will often times not only tolerate but advance the centralization of economic power, which is totally contradictory.

I fully support this Jeffersonian concept which I believe is the heart of your economic doctrine. I feel something must happen radically to change the trend of this Government.

You mentioned organization. If I were to look at the possibility at the moment, I could easily foresee if this economic difficulty continues, at some period of time in the future, the only people who could operate the timber industry in my State, which is a timber-oriented economy, would be the Weyerhausers, the Georgia Pacifics, Louisiana Pacifics, Boise Cascades.

We are rapidly losing the independent small- and medium-size entrepreneur segment of that industry.

I have nothing against those large corporations except that I fear for our future if they are the only ones who can survive. People fail to realize the ripple effect which results from the loss of businesses in our communities.

It is not only the owners of a mill, but where that mill is the primary enployer in a small community and that mill cannot reopen, the future of that entire community is bleak. We find this happening ever increasingly in Latin America with the tremendous movement of population to the large central urban centers, exacerbating already unsolved social problems. This creates more seeds for violence and instability, thus allowing very little accomplishment from a political or idelogical point of view. I believe the lumber industry in my State is typical of many industries throughout this country, which under present policies, are being squeezed out or destroyed. They are not going to survive this economic system and, therefore, I think it is going to take a very radical departure from present thinking and attitudes to maintain economic democracy.

Dr. Kelso, I hear you saying that without economic democracy, we cannot expect to sustain political democracy and without political democracy, we couldn't expect to achieve economic democracy. And it is just that simple.

Mr. KELSO. Nor should Congress delegate the responsibility to change this system to a secret society, namely the economists. Interestingly enough, Mr. Chairman, the size of enterprise is not necessarily contrary to capital theory. General Motors, if owned by 20 or 30 million people with reasonably sized holdings, and if it paid out its income in dividends fully and regularly and they are not intercepted along the way, could be a wholesome thing.

Chairman HATFIELD. I am glad you made that point because when I mention small- and medium-sized entrepreneurs in one type of industry, what I am saying is access to capital or the inaccessibility to capital, the inaccessibility to credit and the disincentives of the productivity.

## COMMITTEE RECESS

Thank you, very much. We appreciate it.

The committee will recess the hearing, to be reconvened at the call of the Chair.

[Whereupon, at 11:40 a.m., Thursday, March 4, the subcommittee was recessed to reconvene at the call of the Chair.]

# ECONOMIC OVERVIEW FOR FISCAL YEAR 1983

FRIDAY, MARCH 5, 1982

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
*Washington, D.C.*

The committee met at 9:40 a.m., in room 1114, Everett McKinley Dirksen Senate Office Building, Hon. Mark O. Hatfield (chairman) presiding.

Present: Senators Hatfield, Schmitt, Rudman, and Sasser.

## NONDEPARTMENTAL WITNESSES

### OPENING STATEMENT OF CHAIRMAN HATFIELD

### REVIEW OF PREVIOUS HEARINGS

Chairman HATFIELD. The meeting will come to order.

Today's hearing will conclude our economic overview for this year. We have thus far heard from President Reagan's chief economic spokesmen, Secretary Regan, David Stockman and Dr. Murray Weidenbaum, in support of the President's budget request. We heard testimony also from Dr. Alice Rivlin, Director of the Congressional Budget Office, who presented CBO's reestimate of the President's budget. Yesterday we turned to monetary policy and our witness was Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System. Also, Dr. Louis Kelso presented his imaginative ideas for the deconcentration of our economic resources.

### INTRODUCTION OF WITNESSES

In order to provide the committee a perspective on the economic outlook for the Nation from nongovernment experts, and to learn their prescriptions for a return to a vibrant, healthy economy, we have invited a most distinguished group of economists to be with us today. We are delighted to welcome Dr. Herbert Stein, Chairman of the Council of Economic Advisers for President Nixon, professor of economics at the University of Virginia, and senior fellow at the American Enterprise Institute; Dr. Alan Greenspan, Chairman of the President's Council for Presidents Nixon and Ford, and president of Townsend-Greenspan, Inc.; Dr. Charles Schultze, Chairman of the President's Council for President Carter, and senior fellow of the Brookings Institution; and Dr. Lester Thurow, professor of economics, Massachusetts Institute of Technology.

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The committee would profit immensely if we could devote an entire week to each of our witnesses. Unfortunately, we have only one morning to dedicate to this. So I ask each witness to summarize his statement briefly and then we will entertain questions from the committee. The entire statement will be placed in the record.

Dr. Schultze has a schedule conflict and can only be with us for the first part of this session. So I will exercise the prerogative of the Chair and ask him to present his case first and then we will move to the panel discussion. Dr. Schultze.

## THE BROOKINGS INSTITUTION

## STATEMENT OF CHARLES L. SCHULTZE, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Dr. SCHULTZE. Thank you, Mr. Chairman. I apologize for the schedule mix-up. I have to be out of hear by 10:30, but let's see what I can do very briefly.

Mr. Chairman, while no budgetary actions are irrevocable, the Congress this year is faced with the necessity to make decisions that will set the basic course of budgetary policy and affect the performance of the American economy for years to come. I would like to offer a few thoughts on four major questions that are relevant to those decisions.

My testimony is unfortunately lengthy and I will summarize it briefly for you. I would hope the testimony could be put in the record.

### QUESTIONS ON BUDGET DEFICIT

The four questions I would like to touch briefly are:

First, How large is the budget deficit likely to be in the absence of further actions to reduce it? How big is the problem in front of you?

Second, how important is it to lower the deficit? Is deficit reduction alone an answer to the century's economic problems? Should a large reduction in the deficit be accompanied by an easing of monetary policy?

Third, can the deficit be reduced sufficiently by the administration's proposed approach of small tax increases, exempting defense and social security from cuts, and concentrating the spending reductions in the remainder of the budget?

And the fourth question, What are the major alternatives for making large reductions in the deficit?

Unless you believe that President Reagan's budget reduction will pass the Congress unchallenged, it seems to me the best measure to start with is the task confronting the Congress, what the deficit would be on the basis of current laws and budget policies. What would the budget deficit be if you don't do anything before you took any actions to reduce it?

## NO-ACTION COURSE ON BUDGET DEFICITS

If you look at the table on page 4 of my testimony, it is an effort to indicate what that budget deficit might be based on no action. The numbers are worked up as an average of two deficits of economic and technical assumptions by the Congressional Budget Office and by the administration. The estimate assumes that the administration's defense program goes forward as planned but, as I said, that no reductions elsewhere are made. The deficits are calculated on the basis of giving two-thirds weight to the Congressional Budget Office and one-third to the administration on grounds that the Congressional Budget Office's economic and technical assumptions seem somewhat more reasonable. It doesn't matter exactly where you draw that average. As you can see, the size of the problem is very, very substantial.

The deficit facing the Congress before any action is taken will amount to something like $165 billion in 1983, growing to $230 billion in 1985. It would grow to 5.5 percent of the GNP by 1985, a magnitude that is unprecedented in recovery period. For example, at the peak of the Vietnam war, when we attempted to finance both the war and Great Society programs with no tax cut increases, the budget deficit was 3 percent of GNP. This would grow to 5.5 percent of GNP if left unchecked.

Clearly deficits of this size must be reduced. But deficit reductions alone are not enough. The Federal Reserve is now engaged on a course of monetary policy that is unprecedented in its tightness. If, under these circumstances, budget deficits rise to unprecedented heights the level of real interest rates will remain at intolerably high levels, with extremely severe consequences for the interest-sensitive sectors of the economy. But the tax increases and spending cuts needed to reduce the deficit will tend to dampen the growth of the demand and spending in other areas of the economy, just at a time when Federal Reserve policy is also very heavily restricting economic growth. The combined degree of economic restraint from both fiscal and monetary policy may then be unnecessarily severe.

This line of reasoning suggests that if truly large reductions in the threatened deficit are put in place, it is imperative that they be accompanied by some cautious relaxation of the present course of monetary policy.

## EFFECTS OF BUDGET DEFICITS ON ECONOMY

Examining this question further, it seems to me, requires you to look at two effects of budget deficits on the economy.

First, borrowing to finance the deficit reduces funds available for private investment. Reducing the deficit, therefore, frees up private savings to support private investment. Looking at it another way, the increase in taxes or decrease in Government spending that lower the deficit also tend to reduce expenditures by consumers and Government, leaving more resources available for capital and raw materials to produce factories, machinery, and houses. Reducing the deficit, in other words, increases the real and financial resources available for private investment.

While reducing the deficit increases the resources that are available for investment, it doesn't itself generate that investment. Raising taxes and cutting expenditures in order to lower the deficit cuts production of consumer goods and goods produced by the Government. A lower deficit does lead to lower interest rates, but there are no economic models that suggest declining interest rates will themselves be large enough to generate the requisite investment to offset Government spending. Take by itself, therefore, a reduction in the deficit will lower total national expenditures by GNP. To maintain the level of total spending and GNP, if that is what is desired, a reduction in the deficit of any large magnitude should be accompanied by some easing of monetary policy to produce interest rates low enough to generate the additional private investment.

Thus, two sets of considerations are relevant in determining the appropriate size of the deficit: Lowering the deficit can change the composition of GNP; out of a given GNP a larger share becomes available for private investment. Reducing the deficit, with no offsetting change in monetary policy, the lower the level of demand, employment and GNP from what they would have been with the higher deficit; to the extent the Government wants to place additional restraints on economic growth that is good. But to the extent that only a change in the composition of GNP is desired, then a deficit reduction should be, ought to be, accompanied by an easing of monetary policy.

## AVAILABILITY OF INVESTMENT FUNDING

Let me turn briefly to the first question, therefore, the size of the deficit and composition of GNP, how much will be available for investment.

If you turn to table 2 on page 8 of my statement there is a table there which attempts to summarize post-war trends in private savings as a percentage of GNP, and then in the second bank of the table tries to summarize the uses of saving for various major purposes. It then projects those savings and their uses out to 1985 just to get some idea where we might be on two different assumptions about the budget deficit.

First what I have shown is the projected deficit before cuts which would amount to $230 billion, or 5.5 percent of GNP, by 1985; and second, after a $150 billion reduction of the deficit by 1985, bringing the deficit back down to slightly under 2 percent of GNP.

As you notice in the post-war period there was a modest growth in private savings as a percentage of GNP, mostly absorbed by financing an increase in the Government deficit, leaving some, but only a slight increase in the very last line on the table, in funds available for investment. That is, you save. Some of it is absorbed to finance the deficit. Some goes for some other purposes, which I note, and what is left over is what is available to finance investment, and unless something is done to check the deficit, if you look in the last line, even after making allowance for some of the tax cut going into saving, a generous allowance, nevertheless what will be available for private investment drops to what I would consider a shockingly low level. And if you remember an awful lot of investment has to go to replace existing plant equipment, leaving very little left over for productivity, expanding, improvement in our capital stock.

Even a large $150 billion cut in the deficit would leave only small room for growth in the funds available for private investment relative to what they were in the prior decade, in the face of a fairly substantial need to increase investment.

So far, therefore, Mr. Chairman, we see that there is a problem with respect to what funds would be available for private investment. Let's now turn to the question of what would happen to the level of gross national product, to the level of output in the face of a significant reduction.

### EFFECT ON GNP FROM SIGNIFICANT REDUCTION

Suppose first the awful combination of a $230 billion current policy deficit and the Fed's tight monetary policy continued for the next 4 years. In my judgment, there would be an explosive collision. On the one hand, the deficit, because of the tax cuts and the increase in defense spending, would be pumping up consumption in defense industries. On the other hand, tight money, keeping interest rates at or above the recent unprecedented levels, over the foreseeable future would keep interest-sensitive industries like auto and housing in a continued depression. We would have an erratic and unbalanced economy. A combination of these could seriously damage the financial structure of American business firms, leading to a much more serious recession and a much more long lasting one sometime in the near future. Reduction of that deficit by $150 billion, as kind of a target, to something slightly less than 2 percent of our gross national product would ease these pressures. But the large tax increases and Government spending cuts needed to reduce the deficit by that much, $150 billion, combined with a continued tight monetary policy by the Federal Reserve would, in my judgment, lead to a very sluggish growth. Perhaps lower interest rates, but very sluggish economic growth even with somewhat lower interest rates. It would be a world in which the unemployment rate probably wouldn't decline much below 8.5 percent over the next 3 or 4 years if you do what you ought to do on the deficit but left monetary policy alone.

While we do need restraint on the economy to prevent inflation from recurring, that would be too much. To maintain the deficit at $230 billion, where it would be with no action, would be—I don't want to use the word catastrophic, but bad, and pulling it down to probably where it ought to be in terms of leaving funds available to invest means it should be accompanied, in my judgment, by an ease in the monetary policy, although a cautious one.

## ACROSS-THE-BOARD ACTION NEEDED IN CUTTING DEFICITS

A large part of my testimony then goes to looking at some suggested possibilities for cutting the deficit, and I won't go through that now except to note it stresses one theme. For economic, social, and above all political reasons, putting together a budget reduction package that will cut the deficit by 1985 by some $150 billion, something along that general ball park, it seems to me that is going to require across-the-board action. In particular, it cannot be done, as the administration proposes, by exempting defense and social security and foregoing any general tax increases. The remainder of the budget simply isn't large enough to support all this reduction. Only if all segments of the budget and society share in the burden of budget reduction can the job get done.

## PROBLEMS RELATED TO BUDGET AND MONETARY POLICY

There are a number of severe problems, however, in trying to put together the necessary package of comprehensive actions on both the budget and monetary policy. Let me close by looking at those problems and making a suggestion.

In recent years it became commonplace for high Government officials, financial executive, and some prominent economists to equate the successful reduction of inflation solely with success in achieving a steady reduction in the growth of the money supply. The toughness and credibility of the Federal Reserve has come to be judged, by a large number of vocal and influential critics, in terms of how firmly the Fed refrains from raising its monetary targets in the face of growing strains and how successful the Fed is in meeting those targets. So the Federal Reserve probably faces, and certainly believes it faces, the problem of worsened expectations in the event it proceeded to either raise its targets for money growth, or to overrun the existing ones. It is widely believed that participants in financial markets would interpret such action by the Fed as a weakening of anti-inflationary resolve, as a consequence of which long-term interest rates might rise rather than fall.

A quite different problem arises for the Congress in trying to put into place an integrated approach which substantially reduces the deficit while moderately easing monetary policy. There are four independent sets of actors who must come into broad agreement to put such a policy together—the Executive, the leadership of both parties in the Congress, and the Federal Reserve.

Without an explicit agreement or accord, each party will find it difficult to act, for quite different reasons. If, for example, either the President or one of the parties in the Congress threatens to make political capital in this election out of efforts by the other parties to cut defense spending or scale back cost-of-living allowances in social security, it will be very unattractive for any one of the actors to take the lead. And if any one major element of the budget, or of society, is exempted from bearing some part of the burden, the coalition needed to enact the necessary package of measures cannot be formed. Similarly, in the case of the Federal Reserve, it cannot risk its anti-inflationary credibility by easing up on its monetary targets in the absence of a firm, and I believe bipartisan agreement, to enact a very large deficit reduction package.

### TOUGH ACTION ON ALL BUDGET FRONTS

It is my judgment, simply from reading the newspapers and talking to people, that large portions of the membership of both parties in the Congress are prepared to take tough-minded action on all the necessary budget fronts. I do not know, of course, what the Federal Reserve would do, confronted with the offer of such an accord as I have described. But I would not rule out the possibility that they would participate. If the media accurately reported on the advice from the economic advisers whom the President overruled when he made his final budget decisions, even those advisers might also find such an approach worthy of consideration. There is only one of the actors who, at the moment, seems bent on a completely different course—the President of the United States. As an optimist, I believe that in the face of the mounting evidence he too will come around before long.

Thank you very much, Mr. Chairman.

Chairman HATFIELD. Thank you very much.

### RELATIONSHIP OF INTEREST RATES TO DEFICITS AND INFLATION RATES

Dr. Schultze, an interesting question has arisen in the testimony we have heard from previous witnesses, and that is to try to identify the relationship between the interest rates vis-a-vis either the deficit or inflation. We have heard testimony to the effect that interest rates parallel the inflation rate more than they parallel the deficits, and we have had statements that no literature has been found in economic history that would indicate they parallel inflation rates. So my question is, from your standpoint as an economist, how do you view the relationship of interest rates to deficits and to inflation rates? If the tight money policy that is now presently employed is loosened, as I understand you have suggested, how would that affect interest rates?

Dr. SCHULTZE. In the first place, Mr. Chairman, it is probably true that if one looks at a simple relationship between interest rates and the deficit one finds either not much connection or in fact a paradox—when deficits are high interest rates are low. Second point—this is not exactly a general statement but it's almost a general statement—any simple relationship in economics anybody hands you is sure to be wrong.

Senator SCHMITT. That is why we have economists.

Dr. SCHULTZE. Very often, and typically in the past, and in the future it will happen the same way, when the economy eases off, when there is a slump or slacking, the deficit gets larger, private demands for credit go down more than the deficit goes up, so interest rates fall. When the deficits get big is in recession, precisely the time when private credit is slumping. That is why you have got the recession. The fact that large deficits are often associated with low interest rates means that large deficits in the past have usually occurred in recessions, when the economy is weak.

However, now postulate an economy which is not in recession, but which is, as assumed by everyone who has been making budget projections in an economic recovery. All economic recoveries are characterized by increases in business and consumer spending. In an economic recovery with private demand for credit going up and the budget deficits going up at the same time, you have a severe problem, because you have both sources pressing on credit.

Finally, it is also true, and it has become fashionable lately, to say, well, to some extent if our interest rates go up we will attract more funds from aboard. It won't be so bad; we will get the needed credit from the foreigners. While it is true to a small extent, it is mainly not the case. We are not going to be able to run the kind of balance of payments deficit to make that possible.

In summary, therefore, it seems to me that under the circumstances you are dealing with, which is not what do we do about a deficit in a recession but what do we do about a deficit that is going to mount during recovery, that deficit, combined with the Federal Reserve policy, is going to put ever greater pressure on interest rates. I think the deficit ought to be reduced. If a large reduction is achieved then I think we can simultaneously, while still pursuing an anti-inflationary policy, ease up on monetary policy cautiously.

## TREND OF INFLATION

Chairman HATFIELD. That would not then, in your opinion, cause a reversal in the downtrend of the inflation rate that has been occurring?

Dr. SCHULTZE. It would not.

Again, I want to note that if one starts with a very small budget deficit reduction, or one which is mainly accounting mirrors, so that you don't contribute much to the anti-inflation fight by reducing the deficit, then I would question whether or not the Fed could or should ease up on money. But granted a really serious effort to get the deficit down along the target I have described, then I think we could stand to modestly ease up. We are still going to have an economy that is going to go through difficult times in the next few years. Every major industrial country in the world is going through it today—how do you bring inflation down? But a much reduced deficit and some eased monetary control could bring us through those problems with a little less pain.

## INTEREST RATES ON LONG-TERM BONDS

Chairman HATFIELD. How do you respond to the Wall Street economists who say there will not be a true economic recovery as long as the long-term bond rates remain around 15 percent? Do you agree with that?

Dr. SCHULTZE. Well, I guess I agree with a lot of the thrust of what goes behind it, if you stress the ideas of a long-term recovery. I am not in the forecasting game, but my judgment would be with a $40 billion tax cut coming in this year, that you will for a time even with high interest rates see some resurgence in the economy. But given the combination of inflation declining slowly and the Federal Reserve determined to feed money out at a very slow rate, I would argue that that is going to get interest rates to the point where that recovery will not last very long in any significant degree. Whether it peters out and goes nowhere or whether we get into another recession in 1983 I don't know.

## STRENGTH OF ECONOMY UNDER PRESENT PROGRAM

Chairman HATFIELD. Given the present economic game plan in place and if it is pursued without major modification by the Congress, Dr. Murray Weidenbaum indicates that 1982 will go "out like a lion." Would you care to make comment on how strong you believe the recovery will be under the present game plan?

Dr. SCHULTZE. Well, I guess if it goes out like a lion under the present game plan it is going to fall into a pit not long thereafter. That wasn't a very good analogy.

Chairman HATFIELD. Thank you.

Dr. SCHULTZE. My colleague suggests maybe like a sick lion.

Chairman HATFIELD. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman. I would like to commend you, Mr. Chairman, for bringing before us today these outstanding economists, and also bringing before us a wide variety of views on the subject of the problem with our economy. I think it is very helpful for us to hear from many, many voices, who might have differing opinions, on what the problem is with the economy and what the possible solution could be.

I am going to direct my questions purely to Dr. Schultze because I understand Dr. Schultze has a time problem with an airplane, so I will make my questions very brief.

## EFFECT ON INTEREST RATES FROM EXCESSIVE FED BORROWING

Obviously, Dr. Schultze, you do subscribe to the crowding out theory, that if the Federal Government is in the borrowing market bellying up to loan windows for substantial amounts that it is going to crowd out investors and raise the level of interest rates. Is that a correct assessment on my part?

Dr. SCHULTZE. I guess I can't refrain from giving a qualification. In a period when the economy is moving prosperously and recovering you are right. I would take exception that it is true in periods of recession, when business credit is weak anyway. To the extent that does happen under recovery conditions you are right.

Senator SASSER. Have we reached a period now where the economy is so weak and demand on the part of business to borrow money has lessened to a degree that there is no crowding out, in your judgment, as far as the Government crowding out private business is concerned?

Dr. SCHULTZE. Well, if I look right at the moment when we are in the middle of a recession, the Federal Government deficit is probably taking up some of the slack from a weak business investment, weak business and consumer demand for credit. So it probably isn't crowding out much. Again, you ask what would the world be like if you didn't have the Federal Government's deficit, if right now it were zero, and I say you tell me what you did to get rid of it, and you would have either raised taxes or cut spending. You would find two things. You would have a worse recession but lower interest rates. But if in the middle of a recession you get rid of the deficit you will drive the economy down further. The real problem is not the 1982 deficit, it is what is going on out in 1983, 1984, and 1985, and what I see is the economy trying to recover with the deficit going up.

Senator SASSER. So it is not the deficits, in your judgment, that are now the real problem.

Dr. SCHULTZE. Precisely. Most of the things Congress does won't have an effect immediately, but out in the future, and your actions will have an effect out in the future.

### EFFECT OF REDUCED UNEMPLOYMENT ON FEDERAL DEFICIT

Senator SASSER. Would you agree, Dr. Schultze, or is this a valid statement, that if we could reduce unemployment by 4 percent in this country that we would go a long way toward reducing significantly the Federal deficit?

Dr. SCHULTZE. Well, yes, and it is almost irrelevant.

Senator SASSER. Why is it irrelevant?

Dr. SCHULTZE. If by waving a magic wand I could get unemployment down to 4 percent, it surely——

Senator SASSER. Reduce it by 4 percent.

Dr. SCHULTZE. Yes; but it would be down to 4.5 percent, or as of this morning it would be down to 4.8 percent.

Senator SASSER. Five percent.

Dr. SCHULTZE. If you could wave your hand and do that the deficit would be substantially better.

Senator SASSER. How, wiped out?

Dr. SCHULTZE. It would be wiped out, yes. It is irrelevant because one doesn't wave one's hand. One gets unemployment down by some combination in terms of what we do in monetary and fiscal policy. And the question is what would happen to inflation if you pushed the economy ahead so fast. The economy would have to grow about 10 percent above what it is now all at once. I don't know what would happen to inflation and interest rates. If you can do it, fine. But the problem we are facing is how.

Senator SASSER. Let me tell you why I am pursuing this line of questioning. I come from a Sunbelt State. We have presently in that State an unemployment rate in excess of 12 percent, the highest unemployment rate we have had in our State since we started keeping records. Now I think that unemployment rate of 12 percent is erroneous. It does not count the people who quit looking for jobs. It does not count tens of thousands of unskilled blacks in Memphis, Tenn.. Now what I am searching for is some way to put these people to work in a productive way that would help us reduce the deficit.

### WORLDWIDE UNEMPLOYMENT

Now this is the problem we have here in the United States, but we see it being shared by our trading partners and our allies in Western Europe. Their unemployment rates are going up to the levels as high as they have been since the Great Depression. They are also having severe economic difficulties.

What can we do to put these people back to work and make our economies more productive? That is a very broad, unfocused question. I am aware of that. But that is something that is very troubling to me. What is causing this widespread, worldwide unemployment?

Dr. SCHULTZE. Let me start with that last question first. In my judgment what is causing the worldwide unemployment is primarily—not solely, but primarily—the fact that every government in the world is pursuing some combination of tight money and trying to pursue, in many cases, tight fiscal policy to wring inflation out. At least in the short run when we lean on the economy we make markets weak. We are trying to force business and labor to moderate their wage and price increases. We find, unfortunately, some of that force goes not into lower prices but into lower output and employment. That is exactly what is happening all over the world. I don't think there is a way out of that easily. We are going to have to suffer some of it. I do think the first and best thing we can do is a combination of fiscal and monetary policy over the next 3 to 4 years which provides for a moderate growth in output and a gradual reduction of that unemployment, recognizing we cannot afford to do it too rapidly simply because we will gin up inflation again. That is one set of answers.

There is a second set, not so much of answers but something we have to look at. I think most people are out of work because nobody wants to buy the products they would produce if they were at work, so they can't find a job. One way to handle that is a combination of monetary and fiscal policy which makes the overall economy move ahead moderately.

The second problem is skills, ability to fit into the modern labor market, whether or not they are educated enough. These are all the things that go with programs of training and education to try to improve the quality of the labor force. That is a second set. I must confess I don't have any particular expertise on how one can better design the education or training system in the country to do that. That is something that is relevant I think.

Chairman HATFIELD. Thank you very much, Senator Sasser.

Senator Schmitt.

Senator SCHMITT. Thank you, Mr. Chairman, and thank you, gentlemen, for being here with us this morning.

### EFFECT ON INTEREST RATES FROM PERSONAL SAVINGS

Dr. Schultze, what do you think would happen if we had a doubling of the personal savings rate?

Dr. SCHULTZE. Three things would happen. One, we would get a very huge relative drop in consumption initially, and people producing in the consumer goods industries would be in real trouble. Two, interest rates would fall to some extent. Three, we would get some investment increase. A big jump in the savings rate would lower the GNP, result in more unemployment but somewhat lower interest rates. If we double the savings rate we would need to make sure we not only let interest rates come down but we do something actively to ease up on monetary policy, I think.

Senator SCHMITT. But if you combined that kind of a magic wand applied to the savings rate with cautious easing of money supply, the GNP problem might correct itself.

Dr. SCHULTZE. That is right. Obviously what an increase in the saving rate does, it makes more saving available for real capital formation.

Senator SCHMITT. So it increases the pool of capital from which public and private credit could draw.

Dr. SCHULTZE. Correct. And you have to make sure incentives are there for product investment. That is not going to necessarily happen automatically.

### JAPANESE PER CAPITA DEFICIT

Senator SCHMITT. Is that basically the situation that the Japanese have faced in recent years, with a high per capita deficit but nevertheless a high savings rate which tended to make it tolerable to have a high deficit?

Dr. SCHULTZE. Yes, sir. They run a government deficit that by our standards would be shocking. But they have a huge saving rate and somewhat lower investment opportunities than they used to have. You are exactly right.

Senator SCHMITT. You indicated a few moments ago that it was your feeling that it was not just this current administration, the Congress that had made a decision to fight inflation as the No. 1 problem, but it is worldwide; is that correct?

Dr. SCHULTZE. Yes; I would even want to mention the last administration but I——

Senator SCHMITT. Somehow they were unable to mobilize the same support in Congress as the current administration, or the Federal Reserve System, to hold the money supply growth at a more reasonable level.

But with inflation down in the last few months, CPI inflation indicating somewhere below 6 percent, maybe even below 5 percent; if that were to hold out say 6 percent, plus a 3 percent basic cost of money that would mean interest rates at roughly 9 percent, yet we are seeing short-term interest rates hovering around 16 percent, that is 7 percentage points above the level I mentioned, this is about 4 points greater than is normal for the difference between short-term interest rates and inflation plus the cost of money. How long can that last and where are those other 4 points going? Can't the financial markets pull us out of this thing by taking at least those 4 points out of the interest rates?

Dr. SCHULTZE. At the risk of oversimplifying, there are really two things that go into interest rates, long-term interest rates. That has to do with expectations of inflation, but it also has to do with expectations of real future interest rates. And if the markets believe that future inflation is going to be down, but down only gradually, and if in addition those markets believe that you have a combination of very tight money from the Fed and very high deficits, the current bond rate now is going to reflect not only inflation, but they are going to expect continued interest rates that are much higher than inflation. That is because interest rates don't just follow inflation, they follow a combination of inflation and a real pressure in the money and credit market. And there is real pressure, given the Fed on the one hand and deficits on the other are pretty strong.

Senator SCHMITT. Yes; but the inflation rate expectations are real and interest rate expectations are as you have indicated very critical in determining where interest rates are and where they are headed—and we have had a dramatic decrease in inflation. I don't think there is any question about that. And the environment that we see that would contribute to inflation right now is positive. That is, inflation is going to be low and presumably remain low and get lower if we stick to those particular policies.

Dr. SCHULTZE. The one thing you have to worry about is what is happening not only in the publicized area of wage concessions to the basic thrust of wage increases generally, and I am not yet convinced they have come down a lot.

Senator SCHMITT. But we even have positive trends there.

Dr. SCHULTZE. What we don't know is how much those concessions are spreading.

## CONTROLLING INFLATION

Senator SCHMITT. Would you agree that whatever we do we ought to be very, very cautious of not letting inflation get out of hand?

Dr. SCHULTZE. I agree. That is one of the difficulties of running economic policy. Where is the balance?

Chairman HATFIELD. Thank you very much, Senator Schmitt.

Senator Rudman.

## COMPROMISE NECESSARY IN U.S. ECONOMY

Senator RUDMAN. Dr. Schultze, I wouldn't help but think as I listened to your excellent testimony this morning of those several years ago when I would get up early in the morning and watch you and Alfred Kahn. Even the slightest glimmer would be greeted with great joy that the inflation rate maybe was going to move down. Of course, it didn't. Probably no fault of yours. But we forget very quickly. The walls of this hearing room I expect heard very little about unemployment and very little about interest rates. All I heard about as a private citizen was the inflation rate. We heard and heard and heard. That was the national concern. Now that it appears to be going down, now we are switching focus, and my friend from Tennessee wonders what would happen if we could suddenly reduce unemployment to 4 percent.

I want to just read something to you and ask whether you agree with it or not. I am sure that the author of this is one who is known to all of you, Alan Sinai, who is vice president of Data Resources. And he wrote a piece in the Boston Globe a couple weeks ago that I think says pretty much what you said. What his headline is, is "Without Compromise the United States Economy is Headed for Collapse." That is a fairly grim headline. And what he says here simply is, and I will read you the key paragraph, "The results from a compromise toward a tighter fiscal, easier monetary policy"—you would use the word cautionary—"would be much lower deficits, reduced interest rates, no loss of growth and real GNP somewhat lower and a much better performance of interest-sensitive areas of the economy. A much better balance would be struck in the distribution of the impacts from the strong anti-inflationary course set by the administration and the Federal Reserve. One thing is for sure, without a compromise now in the current thrust of policies, the U.S. economy runs the risk of a major collapse unprecedented in the post-war period."

I want to ask you whether you agree with that.

Dr. SCHULTZE. Yes, sir. I don't like the word collapse, but basically I agree. I think the word "collapse" is strong. But very bad.

Senator RUDMAN. Would you just give me some numbers. What do you mean by very bad in terms of various numbers you economists usually talk about?

Dr. SCHULTZE. I don't know. What at least I don't have any sense of in terms of numbers is what happens to an economy that faces 5, 6, 7 percent real interest rates for a number of years; what happens to the financial structure of business, the quality of credit? Could you get into a major crunch of financial institutions? The sort of thing we have avoided throughout the postwar period is a financially induced, long-lasting recession of a variety I can't begin to imagine. That is the danger. At the moment I wouldn't predict it, but that is the danger. I don't know what numbers to put on it because, quite frankly, I am not sure how to trace it through. I would not have used the word "collapse," but would have severe difficulties if you kept on this course.

Senator RUDMAN. So really the bottom line is what you spoke early on about, almost an Alice in Wonderland situation, where we could reach a happy compromise which neither party would use as a club against the other major areas of compromise such as reductions in defense spending. Essentially what you are saying, unless during this session of the Congress we address it forthrightly and essentially made a midcourse correction in the present economic policy, you agree with Mr. Sinai unless we do that we are going to have major dislocations.

Dr. SCHULTZE. The risk of it gets higher.

Senator RUDMAN. Thank you very much, Dr. Schultze.

Chairman HATFIELD. Thank you, Senator Rudman.

## PREPARED STATEMENT

Dr. Schultze, I think we have completed our questioning in time for you to meet your schedule. Thank you for your contribution. We will insert your prepared statement in the record at this point.

Dr. SCHULTZE. Thank you, Mr. Chairman. I apologize to my colleagues here for taking so long.

[The statement follows:]

# PREPARED STATEMENT OF CHARLES L. SCHULTZE*

SENIOR FELLOW,

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Mr. Chairman and members of the Committee:

While no budgetary actions are irrevocable, the Congress this year is faced with the necessity to make decisions that will set the basic course of budgetary policy and affect the performance of the American economy for years to come. I would like to offer a few thoughts on four major questions that are relevant to those decisions:

1. How large is the budget deficit likely to be in the absence of further actions to reduce it? How big is the problem in front of you?
2. How important is it to lower the deficit? Is deficit reduction alone an answer to the century's economic problems? Should a large reduction in the deficit be accompanied by an easing of of monetary policy?
3. Can the deficit be reduced sufficiently by the Administration's proposed approach of small tax increases, exempting defense and social security from cuts, and concentrating the spending reductions in the remainder of the budget.
4. What are the major alternatives for making large reductions in the deficit?

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*The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

## How Large is the Budget Deficit Likely to Be?

The most recent estimates of the budget deficit by both the Administration and the CBO, are based on the assumption that the Administration's budget reduction program is enacted in full. Unless one believes that this program will pass the Congress unchallenged, a more relevant estimate of the magnitude of the task facing the Congress is a measure of what the deficit would be on the basis of current laws and budget policies, in the absence of any actions to change them. What is the size of the problem you start with? Table 1 below shows the size of that current policy deficit -- based on both Administration and the most recent CBO estimates. (The estimates in Table 1 assume that the Administration's defense program goes forward unchanged.)

Table 1. The Budget Threat: Current Policy Budget Deficits Before Reductions, Based on Administration and CBO Estimates; FY 1982-1985 (billions of dollars and percent)

| | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| Billions of dollars: | | | | |
| Administration | 101 | 149 | 178 | 189 |
| CBO | 112 | 172 | 216 | 252 |
| Percent of GNP: | | | | |
| Administration | 3.3 | 4.4 | 4.7 | 4.5 |
| CBO | 3.7 | 5.0 | 5.7 | 6.0 |

Source: Author's calculations based on Administration and CBO Budget Documents. The estimates include the increase in interest payments on the public debt brought about because deficits themselves increase the public debt.

On either set of estimates the deficit, in the absence of further actions to reduce it, would rise to an unprecedented magnitude by 1985, especially when we remember that the calculation of both the CBO and the Administration assume an economic recovery beginning this year and lasting through 1985. Measured as a percent of GNP the highest non-recession deficit in postwar history was reached fiscal 1968, at the peak of the Vietnam War, when it was 3.0 percent, and that deficit helped set off a major inflation.

The estimates of CBO and the Administration differ because of alternative economic assumptions and technical judgements. The CBO economic assumptions are roughly similar to those of most private forecasters. The Administration's are more optimistic. An examination of areas where there are large technical differences -- such as farm price supports and revenues from offshore oil leases -- suggests that the CBO estimates are closer to what might be expected on the basis of past relationships.

For the remainder of the testimony I will use budget figures which average the two estimates, giving two-thirds weight to the CBO's numbers and one-third to those of the Administration. The resulting estimates still incorporate relatively optimistic economic assumptions; economic growth averages 4-1/2 percent a year between 1982 and 1985; inflation falls to 5-1/2 percent by 1985, unemployment 6.9 percent and interest rates on short term Treasury bills to 9 percent by 1985. The resulting deficits are:

| | (fiscal year) | | | |
|---|---|---|---|---|
| | 1982 | 1983 | 1984 | 1985 |
| Billions of dollars: | 108 | 165 | 203 | 230 |
| Percent of GNP: | 3.5 | 4.8 | 5.4 | 5.5 |

Clearly deficits of this size must be reduced. But deficit reductions alone are not enough. The Federal Reserve is now engaged on a course of monetary policy that is unprecedented in its tightness. If, under these circumstances, budget deficits rise to unprecedented heights the level of real interest rates will remain at intolerably high levels, with extremely severe consequences for the interest sensitive sectors of the economy. But the tax increases and spending cuts needed to reduce the deficit will tend to dampen the growth of the demand and spending in other areas of the economy, just at a time when Federal Reserve policy is also very heavily restricting economic growth. The combined degree of economic restraint from both fiscal and monetary policy may then be unnecessarily severe.

This line of reasoning suggests that if truly large reductions in the threatened deficit are put in place, it is imperative that they be accompanied by some cautious relaxation of the present course of monetary policy.

## The Two Effects of Budget Deficits

The existence of a large and continuing federal budget deficit, during a period not characterized by recessions, affects the economy in two major ways.

In the first place, borrowing to finance that deficit absorbs private savings that would otherwise be available for investment in housing or business plant and equipment. Reducing the deficit, therefore, frees up private savings to support investment. Looking at the same phenomenon another way, the tax increases or government spending cuts that lower the deficit tend to reduce expenditures by consumers and government, leaving more resources available to produce factory buildings, machinery, or houses. Cutting the deficit thus tends to increase both the real and the financial resources available for investment purposes, and vice-versa. To the extent that the proceeds of tax cuts are saved, and not spent on consumer goods, this conclusion must be modified. That fraction of a deficit-creating tax cut which is saved doesn't reduce the financial or real resources available for investment (and vice-versa for a deficit reduction financed by tax increases).

While a reduction in the federal budget deficit increases the real and financial resources available for private investment -- by lowering consumption or government spending -- it does not itself generate that additional investment. Lower deficits do tend to produce some decline in interest rates, but there are no economic models which suggest that the decline will be large enough to induce the requisite additional investment. Taken by itself, therefore, a reduction (increase) in the deficit will lower (raise) total national expenditures and GNP. To maintain the level of total spending and GNP, if that is desired, a reduction in the deficit must be accompanied by an easing of monetary policy, to produce interest rates low enough to generate the additional private investment.

Thus, two different sets of considerations are relevant in deciding the appropriate size of the federal budget deficit:

- Lowering the deficit can change the mix of GNP; out of a given GNP a larger share becomes available for private investment.
- Reducing the deficit, with no offsetting change in monetary policy, will lower the level of demand, employment, and GNP from what they would have been with the higher deficit; to the extent the government wants to place that degree of restraint on total demand and employment, as a means of putting further downward pressure on inflation, reducing the deficit is a way to do so. But to the extent that only a change in mix is desired, then a deficit reduction must be accompanied by an easing of monetary policy.

To design a reasonable long term strategy for dealing with the prospective budget deficits that now face the country, it is therefore necessary to decide what we want with respect both to the level and the composition of economic activity. And it is impossible to decide on appropriate long term budgetary strategy without simultaneously making decisions about long term monetary policy.

## The Question of Mix: Federal Deficits and the Investment Share of GNP

Table 2 summarizes postwar trends in the share of gross national income (=GNP) flowing into private savings and the availability of those savings for private investment. In order to assess the longer term implications of sustaining large budget deficits, it also projects the savings ratio and investment availability to 1985 under two different assumptions about the magnitude of the deficit that will have to be financed.

Table 2. Private Savings and Its Uses in the United States, as a Percent of GNP, 1951-1980 and Projections to 1985

| | | | | 1985 | |
|---|---|---|---|---|---|
| | 1951 to 1960 | 1961 to 1970 | 1971 to 1980 | A: $230 billion deficit | B: $80 billion deficit |
| Total Private Savings | 16.0 | 16.9 | 17.7 | 19.0 | 18.5 |
| Personal | 4.7 | 4.7 | 4.8 | 4.5 | 4.2 |
| Business | 11.3 | 11.7 | 12.0 | 13.2 | 13.0 |
| State and local pension funds | ... | 0.5 | 0.9 | 1.3 | 1.3 |
| Total Uses of Savings | 16.1 | 16.8 | 17.9 | 19.0 | 18.5 |
| Less: financing the federal deficit | 0.2 | 0.5 | 1.9 | 5.5 | 1.9 |
| Financing state and local deficits | ... | 0.5 | -0.1 | 0 | 0 |
| Net foreign investments | 0.3 | 0.5 | 0.1 | -0.3 | 0 |
| Equals: amount available for private investment: | 15.6 | 15.3 | 16.0 | 13.8 | 16.4 |

Private savings is made up of two major components: personal savings and the gross retained earnings of business firms (undistributed profits plus depreciation allowances).[1] As the table shows, the nation has modestly increased the share of income going to private savings in each of the last two decades. All of this increase has been in the form of human savings -- the personal saving share did not rise (and indeed in the last half of the 1970's it declined substantially). All the rise in the private saving ratio from the 1950's to the 1970's was absorbed by an increase in size of the federal deficit which had to be financed. But the effect of this on the availability of financial and real resources for private investment was moderated by a swing from deficit to a small surplus on the part of state and local governments and by the decline of U.S. foreign investment. Despite the rather large rise in the amount of savings required to finance the federal deficit, therefore, a slight increase in the availability of funds for private investment did take place.

To show the magnitude of the current problem, the projection to 1985 labeled "A" in the Table 2 incorporates the $230 billion federal deficit that will be forthcoming by 1985 if no actions are taken to reduce it. The "B" projection assumes that the deficit is reduced by $150 billion, to a level of $80 billion.[2]

The estimate of private savings in the "A" projection assumes, optimistically, that individual and corporate tax reductions in the Economic Recovery Act of 1981 significantly raise private savings. While the Act does substantially lower effective tax rates from what they otherwise would be, the average effective tax rate on individuals falls only to about what it was in 1978 or 1979 and marginal effective rates for most taxpayers are similarly brought back to the levels of the late 1970's. Much of the tax reduction simply offsets bracket creep that otherwise would have occurred. Nevertheless the projection assumes that the personal savings rate out of disposable income would rise by a full percentage point, from the 5.6 percent it averaged in the last half of the 1980's to 6.6 percent in 1985. Business savings as a percent of GNP were assumed to continue on their modest upward trend and were then raised further by an amount equal to 60 percent of the corporate tax cut (the other 40 percent going to dividends).

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[1] The flow of savings into pension funds for employees of private firms is part of private savings. The net flow of funds into pension funds maintained by state and local governments on behalf of their employees is exactly the same in character and is thus classified under "private savings" in Table 2.

[2] Because actions to reduce the annual deficits between now and 1985 lower the public debt, and hence interest payments, a deficit reduction program of about $50, $90, and $125 billion in fiscal years 1983 through 1985, would produce a deficit reduction of $150 billion in 1985.

State and local governments in the aggregate were assumed to run a balanced budget (although the combination of cuts in federal grants-in-aid and the aftermath of events like Proposition 13 could put them in deficit). It was assumed that some part of the needed financing would come from abroad, in the form of a U.S current account deficit, but the magnitude of this relief is limited. Foreigners would be unwilling to finance a huge U.S. current account deficit, and exchange rate movements (a depreciation of the dollar) would limit financing from this source.

As shown in the last bank of numbers in Table 2 failure to reduce the federal deficit very substantially below the levels now in prospect would sharply lower the availability of funds for private investment. The 13-1/2 percent of GNP which would be available for investment is far below any postwar experience. Housing construction would necessarily fall even lower than at present. The "crowding out" of private investment would take place through the mechanism of very high interest rates, maintained over a long period of time. Since the nation has no experience with such a situation there is little basis on which to predict the consequences. But it is at least conceivable that severe financial strains would develop leading to a major credit "crunch" and a subsequent recession longer and deeper than any in the postwar period.

In would take a reduction in the 1985 deficit of almost $150 billion to make available for private investment (on relatively optimistic assumptions) a share of resources larger than that which prevailed in the 1970's. It is probably reasonable to assume that housing investment would not return fully to the same share of GNP it had in the 1970's, partly because mortgage interest rates are likely, in the best of circumstances to remain well above historical levels. Consequently, case "B" makes room for a somewhat larger rise, above the average of the 1970's, in the share of GNP going to business investment. But even with the major deficit reduction program that underlies case "B", the room for a rise in investment is modest, especially in view of the nation's poor productivity performance and its need for a sharp increase in investment. A year ago, Secretary of the Treasury Regan, appearing before the Congress, projected a rise in the private investment share of GNP of some 4 percentage points between now and 1986. It will take a massive deficit reduction effort to make room for only a small fraction of that increase.

So far, the discussion has assumed a particular path for the growth of total GNP, and concentrated on the question of its composition -- how much of the assumed GNP will be available for investment. But given the current trend of monetary policy which will yield very slow growth in the money supply and historically very high real interest rates over the foreseeable future, it is not at all clear that investment will be forthcoming in sufficient volume to absorb the real and financial resources available, even with a federal budget deficit that is reduced to 2 percent of GNP. In that case GNP will rise by less than the projections assume, and unemployment will remain high.

And so the second aspect of a deficit reduction must be considered -- its effect on the level and rate of growth in GNP and the relationship between deficits and monetary policy.

## The Federal Budget and the Level of GNP

There is no historical precedent, outside of the two world wars, for a non-recession deficit equal to the 5.5 percent of GNP which is likely to occur without the inauguration of a major deficit reduction program. The stimulative effect of such a deficit on the demand for goods and services, especially in the consumer goods and defense industries, would be very great. While budget policy, without correction, would be stimulative to an unprecedented degree over the next three to four years, monetary policy has been set on an equally unprecedented course of restrictiveness. Already, even before the worst of the deficits have occurred and in the midst of a recession, long term interest rates both absolutely and in relation to inflation have climbed to postwar peaks, partly in expectation of this policy conflict.

Since there is no precedent either for the stimulative magnitude of the prospective deficits or the restrictiveness of the announced monetary policy, it is virtually impossible to analyze the ramifications of the conflict. Conventional analysis, looking to historical relationships between money, interest rates, deficits and private demand for goods and services, suggests an outcome in which the large tax cuts, the rapid defense buildup, and other elements adding to the deficit would generate enough growth in the non-interest sensitive parts of the economy to offset the effects of monetary policy, but perhaps not by enough to launch major new inflationary pressures. On average real interest rates would continue for the forseeable future to equal or exceed the current unprecedented levels of the last six months, but both interest rates and economic activity would fluctuate erratically. Interest sensitive industries -- autos, housing, inventory goods -- would continue at very depressed levels.[3]

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[3] With today's tight money, unchecked budget deficits of the magnitude shown in case "A" of Table 2 would guarantee a highly erratic and unbalanced economy. With easier money those deficits would guarantee a renewal of inflation.

Conventional analysis does not take into account what a long period of interest rates at this level would do to the financial viability of American business. Three to four more years of today's interest rates could cripple large parts of the thrift industry. For nonfinancial businesses, the threat of bankruptcy potential inability to cover debt service, and deteriorating credit worthiness could give rise to a phenomenon that has been avoided in the postwar period -- a financially induced economic contraction of long duration.

Large tax increases and spending cuts sufficient to reduce the budget deficit by the $150 billion shown in case "B" of Table 2 would lead to lower interest rates, but also to a slower growth of GNP. That is, the induced fall in interest rates would only partially offset the lower growth of demand brought about by the tax increases and spending cuts. The growth of GNP and employment would decline. The question is, what would that growth be and would it be lower than necessary to continue a policy of reducing inflation?

Typically in their first three years, postwar economic recoveries have produced an average annual growth rate of some 5 percent. While recoveries differed, real interest rates (nominal interest rates less the inflation rate) averaged 1-1/2 to 2 percent. With the partial exception of 1972-73 and 1978, these recoveries were not driven by stimulative budget policies. If real interest rates were now set at the same low (2 percent) level, and the deficit were reduced to about 2 percent of GNP (as in case "B") there is no reason to believe that the forces now making for recovery would be any weaker than the postwar average. Abstracting from whether it would have inflationary consequences, economic growth of 5 percent a year for the next several years would be possible (lowering the unemployment rate to perhaps 6 percent or less by 1985). But with the money supply scheduled to grow at only 4 to 4-1/2 percent a year, and inflation declining only gradually over the next three years, even a major deficit reduction plan is still likely to leave real interest rates far above their usual recovery levels. Long term interest rates are likely to average five to seven percent, rather than two percent, above inflation. Even without factoring in the effects of the continued high interest rates on the financial structure of business, economic growth would, therefore not be likely to average above 2-1/2 or at best 3 percent per year. In that case the unemployment rate would not fall much below 8-1/2 percent over the next three to four years.

A policy under which unemployment averages in the neighborhood of 8-1/2 percent for the foreseeable future, however, is more rigorous than necessary to maintain progress in reducing inflation. With a truly large deficit reduction program in place, it would be possible to ease monetary policy cautiously, without abandoning the fight against inflation, aiming perhaps to raise the average growth of GNP during the 1982-185 period by a percentage point or so, to about 4 percent. Conceivably, of course, continued tight money and unprecedented levels of interest rates would stimulate the public to invent innovative ways to conserve their holdings of cash balances, so that the Fed's current money targets would permit lower interest rates and higher growth. But this would be easier money achieved by sheer good luck rather than design, and surely such a development can't be counted on.

In summary a major deficit reduction program is called for -- sufficient to lower the threatened deficit by at least $150 billion. But once credible actions are underway to produce a deficit reduction that large, or larger, some easing in monetary policy ought to be forthcoming.

## Reducing the Deficit: The Administration's Approach

Budget actions which provide substantial reductions in the deficit over several years bring an added bonus; because they slow the growth of the public debt they lower expenditures for interest payments.[4]

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[4] The lower deficits would also bring somewhat lower interest rates, even without a change in monetary policy. However, the economic assumptions used in both the CBO and Administration projections already incorporate a substantial fall in real interest rates. A further reduction seems unlikely.

Hence a combination of tax increases and spending cuts starting at some $50 billion in 1983 and growing to $125 billion in 1985 would make possible the target deficit reduction of $150 billion in 1985.

The Administration has proposed a deficit reduction program which, by 1985, would amount to some $90 billion.[5] That deficit reduction program seeks to maintain intact the basic thrust of the Administration's 1981 economic and budgetary program: the planned buildup in defense spending would go forward unchanged, social security programs would not be cut, only small tax increases would be proposed, and the bulk of the budget cuts would be concentrated in the same broad area as were the spending cuts last year -- i.e., in the 25 percent of the federal budget outside of defense, interest, and entitlement programs.

Because the Administration's approach to deficit reduction exempts defense and social security and precludes any large tax increases, it necessarily concentrates the cuts in a relatively narrow part of the budget -- one which was already slashed sharply last year. Due to this concentration on a small part of the total budget, the additional spending reductions proposed by the Administration, coming on top of last year's cuts, would require quite drastic reductions in many federal activities. As shown in Table 3, for example, federal expenditures on all civilian programs, other than net interest and payments to individuals, would be cut almost in half between 1980 and 1985 when measured in inflation adjusted terms. As a share of GNP, these federal programs -- covering such diverse activities as support of education and training, R & D, maintenance of the National Parks, the expenses of the FBI and construction of federal-aid highways --

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[5] According to the Administration's own estimates its deficit reduction program would result in savings of some $100 billion by 1981. However, as a recent analysis by the CBO has pointed out, several of the proposed savings are questionable, especially the $5 billion additional revenue from offshore oil receipts, the $4 billion in extra sales of public land and other property, and $4 billion in savings from lower growth in the nation's medical care costs which was imputed to a health care legislative program about which specifics are not yet available. The Administration's estimated $100 billion estimate of savings has therefore been discounted conservatively by $10 billion.

would fall to levels below any reached in the last forty years. Table 4 illustrates the magnitude of the reductions for a number of particular federal programs. While the federal government would remain a major force in channeling cash and payments for medical care between taxpayers and various beneficiaries, its role in delivering or supporting state and local delivery of public services would be radically reduced. Precisely because the service support and delivery

Table 3. Expenditures for "Payments to Individuals" and "All Other" Federal Civilian Programs (excluding interest), Assuming Enactment of the Administration's Current Proposals
(in constant prices and as a percent of GNP)

A. Constant (FY 1981) Prices (billions of dollars)

| | Actual | | | | | Proposed | |
|---|---|---|---|---|---|---|---|
| | 1940 | 1950 | 1960 | 1970 | 1980 | 1983 | 1985 |
| Payments to individuals[a] | 9.2 | 44.6 | 62.4 | 132.8 | 295.4 | 319.8 | 326.5 |
| All other programs[b] | 47.5 | 60.4 | 59.4 | 98.8 | 141.7 | 88.9 | 75.5 |

B. Percent of GNP

| | Actual | | | | | Proposed | |
|---|---|---|---|---|---|---|---|
| | 1940 | 1950 | 1960 | 1970 | 1980 | 1983 | 1985 |
| Payments to individuals[a] | 1.7 | 5.1 | 9.7 | 6.5 | 10.6 | 10.7 | 10.0 |
| All other programs[b] | 5.9 | 4.6 | 3.5 | 4.4 | 5.0 | 3.0 | 2.3 |

NOTE: This table is derived from Administration's budget estimates.

a. All programs labeled in the budget category "payments to individuals" except military retirement (included in "defense"). Its major components are: civilian retirement and insurance programs, Medicare and Medicaid, welfare (AFDC, SSI and food stamps), student loans, housing assistance and veteran's pensions and compensation.

b. The "all other" program category shown in the budget document nets out several major categories of "offsetting receipts", which are treated as negative expenditures -- receipts from offshore oil leases, sale of federal land (from 1983 on) and the federal contribution to civil service retirement. The "all other" category in this table is gross of these asset sales.

Table 4. Percentage Reduction in Outlays for Selected Programs, Adjusted for Inflation, 1981 - 1985[a]

| | Percent change |
|---|---|
| Criminal justice assistance | -90 |
| Training and job programs | -72 |
| Energy research and development | -62 |
| Education | -50 |
| Recreational resources | -43 |
| EPA regulations enforcement and research | -42 |
| Social services | -41 |
| Transportation | -35 |
| Area and regional development | -35 |
| Management of national forests | -29 |

a. Based on Administration budget estimates, deflated by the implicit deflator for "All other programs" in Table 22, p. 9-61 of the Budget of the United States, Fiscal year 1983.

role of the federal government, measured in dollars, is relatively small compared to its role in providing defense and making transfer payments, even radical reductions in this role fail, by a wide margin, to eliminate the swelling budget deficit.

I do not wish to suggest that there is no room for additional cuts in this area of the budget. There are some of the Administration's proposed cuts, which it seems to me, have merit. And the Congressional Budget Office has identified a number of spending cuts, outside of entitlement programs, which deserve serious consideration and which would reduce outlays some $18 billion by fiscal 1985.

In my judgement, however, there are two major reasons to turn to other areas of the budget to find additional reductions: , First, apart from the questions it raises on substantive grounds, concentrating budget reductions in the very narrow area proposed by the Administration would make it impossible to secure the social and political consensus needed to reduce deficit by the needed amount. And second, even complete enactment of the Administration's program would still leave an additional $35 to $40 billion in budget reductions to be found (by 1985). There can be no major "untouchable" elements in the budget. The social and political consensus required to take actions of the magnitude that is called for will not be forthcoming if any major sector of the budget or of society is exempt. In particular, the program must include cuts in defense[6] and social security and must require some sacrifice from those who received the bulk of the benefits of last year's individual tax cuts.

## Some Additional Candidates for Budget Reduction

The task of finding deficit reductions that, by 1985, will add up to something in the neighborhood of $125 billion is no mean task. But once the area of search is enlarged to encompass action on taxes, on social security and on defense, the problem is at least not insuperable. I am not capable of proposing nor do I intend to propose a comprehensive list of actions. But it may be useful to list several possiblities.

### 1. General Income Tax Increases

While there are numerous ways to provide a general income tax increase, two have recently been suggested; an indefinite delay in the third, 10 percent, increment of last year's tax cut, due to take effect on July 1983 and a delay in the introduction of inflation indexing, scheduled to begin in 1985. The third stage of the individual tax cut accounts for about 40 percent of the tax rate reduction enacted last year.

An alternative, that with one exception, would be quite similar in its effect on individual taxpayers, would be the temporary imposition of an income tax surcharge; each taxpayer would calculate his tax and then add a specified percentage (the surcharge) to that tax. Since the top bracket rate was reduced from 70 to 50 percent in the first round of last year's tax cut, postponement of the third stage of the tax cut would have only a slight affect on very high income taxpayers. The surcharge, on the other hand, would affect all taxpayers proportionately, and -- to the extent it was desired to stress an even-handed distribution of the burden of deficit reduction -- might therefore be a superior alternative.

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[6] If maintaining the present rapid pace of the defense buildup were clearly essential to national security, an exemption might be feasible. But this is by no means the case and is not generally perceived in Congress to be the case.

Table 5, which shows the revenue gains from the various alternatives, does not include a surcharge or other increase for corporate taxes. Substantial criticism can indeed be leveled at the particular structure of business investment incentives included in last year's Economic Recovery Tax Act.[7] Nevertheless, enacting structural changes in those incentives is highly unlikely to be undertaken this year, and it would be unwise at the present time simply to lower the overall level of incentives provided by last year's Act.

All of the proposals suggested above would raise marginal tax rates, especially on middle and upper middle income taypayers (relative to the rates under ERTA when fully in effect). But economic incentives

Table 5. Revenue Gains from Alternative Income Tax Increases or Deferrals
(billions of dollars)

| | 1983 | 1985 |
|---|---|---|
| Delay third 1983 stage of tax reduction under the Economic Recovery Tax Act of 1981 | 9 | 40 |
| 12 percent surcharge on individual income tax | 37 | 42 |
| Delay indexing | 0 | 12 |

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[7] See for example the vastly different effects on rates of return for investment in various types of plant and equipment as shown in the 1982 Economic Report of the President, Table 5.5, p. 123.

would not deteriorate compared to the current situation. Under the Economic Recovery Tax Act tax cuts for individuals would amount to some $128 billion by 1985. Between October 1981 and 1985 bracket creep due to inflation (using the CBO estimates of inflation) would have raised taxes by $71 billion. Deferral of the third stage of the ERTA, or a 12 percent surcharge, plus postponement of indexing, would still leave the value of the ERA tax cut at $75 billion -- an amount that would almost exactly offset bracket creep. Individual taxpayers would fare differently, with lower and middle income taxpayers being better off under the surcharge. On balance, however, neither approach would significantly worsen economic incentives for individuals compared to the situation in 1981, although the potential improvement under the full ERTA would not be forthcoming.

### 2. Other Tax Proposals

The Administration has proposed specific reforms and related tax changes designed to yield $10 billion of additional revenues in FY 1983 and over $17 billion in 1985. The Congressional Budget Office has identified a very wide range of "loophole closing" measures that add to $34 billion and $72 billion in 1983 and 1985 respectively.[8]

Several of these reforms are particularly relevant to today's problems because they would either reward savings, provide incentives to hold down costs, or address, on the tax side, some of the problems of entitlement programs. (See Table 6.)

One such change, for example, would be a limitation on the tax free portion of employer contributions to medical care plans to $120 per month. The availability of untaxed "low-dollar coverage" insurance, as part of employer paid fringe benefits, discourages the provision of health insurance with significant deductibles and coinsurance. (Taking $100 in the form of a wage increase is taxable; taking $100 in the form of a "richer" medical plan with reduced deductibles or coinsurance in the medical plan is tax free.) As a consequence the medical care system of the nation continually evolves in the direction of removing incentives for the provision of more efficient and lower cost medical care.

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[8] Reducing the Federal Budget: Strategies and Options, (February 1982).

Eliminating the deductibility of interest on consumer installment debt would remove an anomaly in the U.S. tax code that subsidizes consumer borrowing and penalizes saving.

There are several tax reforms that would improve the fairness of entitlement programs -- taxing fully the benefits from unemployment compensation and taxing one-half the retirement benefits from social security recipients earning above $25,000 for couples (and $20,000 for single individuals).

The revenue yield from these various tax measures is shown in Table 6.

Table 6. Revenue Gains from Selected Tax Reforms
(fiscal year; billions of dollars)

| | 1983 | 1985 |
|---|---|---|
| Administration proposals: | | |
| Primarily business firms | 9.2 | 13.3 |
| Primarily individuals | 1.8 | 2.5 |
| Sub total | 10.6 | 15.8 |
| Reforms that help increase savings and/or reduce costs | | |
| Terminate deductibility of consumer interest payments | 1.2 | 8.1 |
| Limit tax free employer contributions for health plans to $120 a month | 2.5 | 4.4 |
| Sub total | 3.7 | 12.5 |
| Reform Tax Treatment of Entitlement Programs | | |
| Tax 1/2 income of retirement benefits for social security recipients with income above $20,000/$25,000 | 1.6 | 2.3 |
| Tax all unemployment insurance benefits | 1.9 | 1.7 |
| Sub total | 3.5 | 4.0 |
| GRAND TOTAL | 17.8 | 32.3 |

## Defense Spending

The defense buildup proposed by the Administration would increase defense outlays between fiscal 1981 and 1985 by almost 9 percent a year faster than the inflation. By 1985 defense outlays will approach $300 billion. The planned growth of R&D and procurement is even more dramatic -- a 75 to 80 percent rise in the real value of procurement and R&D budget authority in four years.

It is widely agreed that the defense budget was underfunded in the 1970's. An intensified program of investment and readiness improvement is indeed warranted. Some of the elements of the currently planned buildup are very questionable however. Do we need a Navy designed with the capability of attacking the Soviet fleet in its home ports? Do we need an MX missile in Minuteman silos. And more important, is not the pace of the buildup too fast even from the standpoint of national security?

An excessively rapid buildup in defense procurement will most assuredly create skill bottlenecks and a scarcity of capacity and managerial talent in important segments of our defense industries. The resulting cost overruns will not be fully financed. The subsequent budget squeeze will not force out the heavy procurement and glamorous weapons surplus. If past history is any guide the squeeze is likely to eliminate expenditures on standard equipment for the ground forces, and such things as ammunition reserves, fuel used in training flights, live use of expensive weaponry in combat training, and a whole gamut of items whose consequences are not so easily seen or measured. The end result of an overly ambitious rate of defense buildup will be to leave our armed forces with too small a quantity of very high priced weapons, and with reduced readiness and less capacity to deploy, use, and maintain them in combat.

I have no menu of specific reductions to offer. But a realistic initial target for the Congress to consider might be the provision of funds for approximately a 5 to 6 percent a year real increase in defense spending. Such an increase would still permit a substantial and expeditious strengthening of the nation's armed forces. Because of the lead times involved the reduction in actual spending would be small in 1983, but would build up to some $25 billion a year by 1985.

## The Need for National Accord on Economic Policy

I think it is possible to design a deficit reduction package of sufficient magnitude to do the job. But, as I said earlier, what is needed is not simply a large reduction in the prospective budget deficit, but simultaneously an easing of the Federal Reserve's current stance of monetary policy. There are some major problems, however, in designing and putting into place a new policy that involves both tighter budgets and easier money. For several years now, it has been commonplace for high government officials, many financial executives, and some prominent economists to equate the successful reduction of inflation with success in achieving a steady reduction in the growth of the money supply. The "toughness" and credibility of the Federal Reserve has come to be judged, by a large number of vocal and influential critics, in terms of how firmly the Fed refrains from raising its monetary targets in the fact of growing strains and how successful it is in meeting those targets -- annually, quarterly, and according to some critics, even monthly. The simple view that anti-inflationary virtue consists solely in a slow growth in money, however inaccurate -- especially under the circumstances we are discussing -- has gained wide credence. Hence the Federal Reserve probably faces, and certainly believes it faces, the problem of worsened expectations in the event that it proceeded either to raise its targets for money growth, or, to overrun the existing ones. It is widely believed that participants in financial markets would interpret such action as a weakening of anti-inflationary resolve, as a consequence of which long term interest rate might rise rather than fall.

A quite different problem arises for the Congress in trying to put into place an integrated approach which substantially reduces the deficit while moderately easing monetary policy. There are four independent sets of actors who must come into broad agreement to put such a policy together -- the Executive, the leadership of both parties in the Congress, and the Federal Reserve.

Without an explicit agreement or accord, each party will find it difficult to act, for quite different reasons If, for example, either the President or one of the parties in the Congress threatens to make political capital in this election out of efforts by the other parties to cut defense spending or scale back cost-of-living allowances in social security, it will be very unattractive for any one of the actors to take the lead. And if any one major element of the budget, or of society, is exempted from bearing some part of the burden, the coalition needed to enact the necessary package of measures cannot be formed. Similarly, in the case of the Federal Reserve, it cannot risk its anti-inflationary credibility by easing up on its monetary targets in the absence of a firm, and I believe bipartisan agreement, to enact a very large deficit reduction package.

It is my judgment, simply from reading the newspapers and talking to people, that large portions of the membership of both parties in the Congress are prepared to take tough-minded action on all the necessary budget fronts. I do not know, of course, what the Federal Reserve would do, confronted with the offer of such an accord as I have described. But I would not rule out the possibility that they would participate. If the media accurately reported on the advice from the economic advisers whom the President overruled when he made his final budget decisions, those advisers might also find such an approach worthy of consideration. There is only one of the actors who, at the moment, seems bent on a completely different course -- the President of the United States. As an optimist, I believe that in the face of the mounting evidence he too will come around before long.

## AMERICAN ENTERPRISE INSTITUTE

## STATEMENT OF HERBERT STEIN, SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE

Chairman HATFIELD. We will now move to Dr. Stein, Dr. Greenspan, and Dr. Thurow, the anchorman, for you to make your presentations. We will have all three of you make your presentations first and then have questions.

Dr. STEIN. Mr. Chairman, we are moving into a situation where there seems to be a great deal of agreement about the course of the economic policy and a great deal of agreement with the description of the present economic situation. That is, there seems to be agreement we are facing deficits for the next several years which are larger than were shown in the administration's budget. There is agreement that this creates serious problems, two kinds of problems. One is that if these deficits materialize they will slow down the long-run growth of the economy by absorbing private savings that would otherwise go into private investment. This is the crowding out process that Dr. Schultze described. And the second problem is that the prospect of these deficits—not the present deficit but the prospect of future deficits—deters recovery from the present recession by keeping present interest rates high, as interest rates are kept high by the fear of future very large deficits in a period of strong economic activity. And there seems to be a consensus growing these deficits should be cut by cutting nondefense spending more than the administration proposes, which means cutting entitlement programs; that we should raise taxes of one kind or another, and that we should cut the growth of the defense program. What I primarily want to do is to indicate the disagreement with one aspect of this common perception, and that has to do with the defense programs.

Making up the Federal budget is the most important exercise in setting national priorities. We should be sure the budget decisions we make conform to our true priorities.

### BUILDUP OF U.S MILITARY FORCES

In my opinion our highest national priority is to build up the Nation's military forces very rapidly. That is more important than balancing the budget, or promoting economic growth, or even than reducing the inflation rate—important as they all are. None of our economic problems can cause an irreversible calamity. Failure to achieve adequate defense can do that.

People I trust—the President and the top officers of the Defense Department—have made an estimate of the expenditures needed to achieve adequate defense. Other people I trust—outside the Government—have independently estimated that we need to spend at least as much as the administration proposed. I would want to see much more evidence that I have seen before I would take the risk of cutting defense expenditures below the administration's proposal. Certainly there is no strong economic argument for such a cut.

We should not be taken in by the argument that because our national security rests upon our economic strength we should cut the defense program in order to make the economy stronger. Our economy is not weak by any measure that is relevant to our national security, and will not be made weak by the proposed defense program.

The budget problem of the 1980's should be looked upon as a problem of war finance. That is, it is a problem of how best to finance the costs of our national security. It is a problem of adapting the budget to the needs of national defense, not of adapting national defense to the needs of the budget.

There may be changes that should be made in parts of the defense program—some increases and some decreases. Those changes should be determined by looking at the specifics of the program in relation to our national security requirements. They should not be arbitrary cuts or ceilings imposed in response to a concern about the size of budget deficits. There are safer ways to eliminate deficits.

### FINANCING OF DEFENSE PROGRAMS

In deciding how to finance the defense program there are two main considerations. First, the defense program may go on at a high level for a long time, and may ever grow larger relative to GNP than is now projected. Therefore, it is desirable to keep the economy growing at a healthy rate, so that the defense burden can continue to be easily borne. Second, the burdens of the program, even though they are not in total very heavy, should be distributed in a way that will be accepted as reasonably fair by the large majority of the American people. Otherwise the program may not have the necessary popular support for the necessary length of time.

### COMPROMISE NEEDED IN SOLVING BUDGET PROBLEMS

I will skip over some small discussion of the requirements for doing these things. But I do want to make this point which agrees with the point that Dr. Schultze made, that this is the time for our political leadership to rise above the temptation to exploit our budget problems for partisan advantage. It is a time for compromise in the interest of national unity, not for dogmatism. The present conflict about the budget is keeping the financial markets in a state of uncertainty and contains great risks of divisiveness. The administration and the congressional leadership of both parties should seek a prompt agreement based on the recognition that there are certain high-priority national objectives and that matters of lesser priority should be the subject of negotiation, concession, and compromise.

### HIGH PRIORITY ITEMS

The high priority items are rapid improvement of our national defenses, preservation of the recent tax revisions that are of most value to economic growth, and a credible course for bringing the budget into balance in the near future. Once that is said, arithmetic—another subject on which compromise is impossible—dictates that we need a tax increase or expenditure cuts beyond those proposed by the President. As a practical matter, the size of prospective deficits is so great that the high-priority goals dictate a tax increase.

The point I want to emphasize is that it is more important to reach an agreement on the budget which the bipartisan leadership can support than for one faction or another to win a victory. Therefore I offer some suggestions for reducing the deficit as indication of the kinds of measures that seem to me economically defensible and fair but without implying resistance to other packages that might yield the same overall budgetary effect.

### SUGGESTIONS ON EXPENDITURE SIDE OF BUDGET

I have some suggestions on the expenditure side of the budget which I will not read, but I assume they will be included in the record. I will say I could not possibly do more than refer to the excellent finding list for savings in the budget that is provided by the Congressional Budget Office report entitled "Reducing the Federal Deficit: Strategies and Options."

We are almost certainly not going to bring the budget into balance in the next 3 or 4 years without some significant tax increase. Even if that could be done it would probably not be desirable to do so. That is, some of the expenditure cuts that would be required would be more harmful than some tax increases. The revenues that may be needed can be raised in any of a variety of ways. My preference would be a combination of energy-related taxes and excises. For example, a gasoline tax of 50 cents a gallon would raise almost $50 billion or an oil import fee of $5 a barrel would raise almost $20 billion. Such taxes would help to reduce dependence on foreign oil as well as raise revenue. Doubling the taxes on alcoholic beverages and tobacco would raise about $7 billion. Such a tax increase can be justified by the large expense the Federal budget now bears to provide medical care for the public. One merit of this general approach is that it would leave untouched the income tax rate cuts made last year and would not introduce unnecessary uncertainty into that aspect of the tax system where predictability is most important to most taxpayers.

Another category of revenue-increasing measures, either in addition to the excises or as alternatives to them, would increase the yield of the income tax without increasing the rates. This would include such measures as eliminating tax exemption for industrial development bonds and terminating the deductibility of consumer interest payment.

Finally, although I should prefer not to go this route, we could defer the income tax rate cut scheduled to take effect in 1983. I would prefer not to do it because I think predictability of income tax rates is important. But we will have to give up some things we value, and I could not object strongly to giving up the 1983 tax cut. I thought the tax reduction in 1981 was much too large; we should be prepared to acknowledge that. As the President said, although in another context, we should be judged not by our mistakes, for we will surely make more of them, but by how well we recover.

## INTERACTION BETWEEN FED AND PRIVATE ECONOMY

I have said nothing about the subjects economists are usually expected to talk about—the recession and how long it will last and whether inflation will continue declining. I have said nothing on those subjects because there is nothing important to say about them in connection with the work of this committee beyond what was relevant to say in regard to other objectives of this committee. I should note that. We are in a recession and the inflation rate has come down. The future of the recession and of the inflation rate will depend primarily on the interaction between the Federal Reserve and the private economy. If the Federal Reserve holds to a policy of monetary restraint and the private economy comes to accept the view that inflation is coming down to stay we will, not immediately but in a reasonable period, come out of our present travail into a condition of greater price stability and strong growth. If either of these conditions is absent—the Fed's persistence or the private sector's response—the course will be rockier. But there is little that the Federal budget can do about that. Budget policy should keep its eye on the long-term goals of defending the country while creating conditions favorable to durable growth and public harmony.

## EFFECT OF GROWTH IN MONEY SUPPLY

I would like to note one point of disagreement with the general line of argument made by Dr. Schultze, most of which I agreed with. But I am concerned about his proposal, which is a common one, that what we need is a package which includes reductions of deficits and something which he calls a cautious change in monetary policy. I think the true situation is that given the present course of the monetary policy as measured by the growth of the money supply, the reduction of present and prospective deficits will reduce real interest rates and will help to revive investment expenditure, but that there is nothing that revision of monetary policy in the sense of an increase in the rate of growth of money supply will contribute to that. If you look at Dr. Schultze's table showing the sources and uses of saving and the way in which the Federal deficit if allowed to continue as projected will crowd out private savings, you will see no dimension of that table which will be favorably affected by an increase in the growth of the money supply. That is, an increase in the growth of money supply is not going to increase private saving and it is not going to reduce the Federal deficit except insofar as it revives inflation, which increases tax burdens, which is something we don't want and have tried to protect ourselves from. So I think it is a mistake to view our problem as a collision course between the easy fiscal policy and tight monetary policy, with the implication that the tight monetary policy ought to yield. We are on a collision course. We are on a collision course between the prospective deficits and savings rates in the country which are not going to be changed by the monetary policy, and we are on a collision course between the conditions in which inflation can come down and employment can be low but monetary policy cannot change that either.

While I am very much in favor of a bargain among the principal actors in the economic policy drama, I would hope the policy would not include an increasing money supply.

PREPARED STATEMENT

Chairman HATFIELD. Thank you, Dr. Stein. We will insert your prepared statement in the record at this point.

[The statement follows:]

# PREPARED STATEMENT OF HERBERT STEIN*

SENIOR FELLOW

AMERICAN ENTERPRISE INSTITUTE

Making up the Federal budget is the most important exercise in setting national priorities. We should be sure that the budget decisions about to be made—by actions or inactions--conform to our true priorities.

In my opinion our highest national priority is to build up the nation's military forces very rapidly. That is more important than balancing the budget, or promoting economic growth, or even than reducing the inflation rate—important as they all are. None of our economic problems can cause an irreversible calamity. Failure to achieve adequate defense can do that.

People I trust--the President and the top officers of the Defense Department—have made an estimate of the expenditures needed to achieve adequate defense. Other people I trust—outside the government--have independently estimated that we need to spend at least as much as the Administration proposed. I would want to see much more evidence than I have seen before I would take the risk of cutting defense expenditures below the Administration's proposal. Certainly there is no strong economic argument for such a cut.

We should not be taken in by the argument that because our national security rests upon our economic strength we should cut the defense program in order to make the economy stronger. Our economy is not weak by any measure that is relevant to our national security, and will not be made weak by the proposed defense program.

The budget problem of the 1980s should be looked upon as a problem of war finance. That is, it is a problem of how best to finance the costs of our national security. It is a problem of adapting the budget to the needs of national defense, not of adapting national defense to the needs of the budget.

There may be changes that should be made in parts of the defense program—some increases and some decreases. Those changes should be determined by looking at the specifics of the program in relation to our national security requirements. They should not be arbitrary cuts or ceilings imposed in response to a concern about the size of budget deficits. There are safer ways to eliminate deficits.

In deciding how to finance the defense program there are two main considerations. First, the defense program may go on at a high level for a long time, and may even grow larger relative to GNP than is now projected. Therefore, it is desirable to keep the economy growing at a healthy rate, so that the defense burden can continue to be easily borne. Second, the burdens of the program, even though they are not in total very heavy, should be distributed in a way that will be accepted as reasonably fair by the large majority of the American people. Otherwise the program may not have the necessary popular support for the necessary length of time.

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*Mr. Stein is A. Willis Robertson Professor of Economics at the University of Virginia and Senior Fellow of the American Enterprise Institute. He is a Member of President Reagan's Economic Policy Advisory Board.

The first issue, restoring and maintaining a healthy rate of economic growth, is essentially an economic one. I think that we know in general what that involves as far as the budget is concerned. It requires that we reduce the budget deficits which are absorbing too large a fraction of the savings that would otherwise be available for private investment. It also means that we should retain the tax changes made last year which most importantly reduced the tax burden on the income from capital. That consists mainly of the acceleration of of depreciation and the elimination of the penalty tax rates, in excess of 50 percent, on personal income from capital.

The other issue, the issue of fairness, is a more difficult one. I suppose that no one ever feels that he is being treated with perfect fairness by the government. What we can aspire to is that not many people should feel acutely that they are being unfairly treated. Even this is difficult when the government intervenes so much in the life of each of us by taking so much of our income in taxes or by offering so much in benefits. There are serious dangers here. We may find ourselves politically unable to support the national programs we need, notably the defense program, because we are unable to agree on how to finance them. Or we may finance needed programs by means whose effects, and therefore whose unfairness, is concealed, especially by large deficits and inflation.

To reach a method of paying for our urgent needs that will be generally accepted as fair requires a high degree of responsibility from our political leadership. Public opinion about what is fair depends heavily on what the public is told by people they respect. If half of the political leadership is telling the taxpayers that they are being unfairly treated because they pay high taxes to support the undeserving poor and the other half is telling the potential beneficiaries of government programs that they are being short changed for the sake of heartless wealthy taxpayers everyone is going to feel misused, and agreement on meeting the nation's urgent requirements will be impossible.

This is the time for our political leadership to rise above the temptation to exploit our budget problems for partisan advantage. It is a time for compromise in the interest of national unity, not for dogmatism. The present conflict about the budget is keeping the financial markets in a state of uncertainty and contains great risks of divisiveness. The Administration and the Congressional leadership of both parties should seek a prompt agreement based on the recognition that there are certain high-priority national objectives and that matters of lesser priority should be the subject of negotiation, concession and compromise.

The high priority items are rapid improvement of our national defenses, preservation of the recent tax revisions that are of most value to economic growth, and a credible course for bringing the budget into balance in the near future. Once that is said, arithmetic—another subject on which compromise is impossible—dictates that we need a tax increase or expenditure cuts beyond those proposed by the President. As a practical matter, the size of prospective deficits is so great that the high-priority goals dictate a tax increase.

The point I want to emphasize is that it is more important to reach an agreement on the budget which the bipartisan leadership can support than for one faction or another to win a victory. Therefore I offer some suggestions for reducing the deficit as indication of the kinds of measures that seem to me economically defensible and fair but without implying resistance to other packages that might yield the same overall budgetary effect.

On the expenditure side of the budget attention naturally and properly focuses on what we have now come to call entitlement programs--which means mainly social security. There is, of course, a special consideration in the case of social security, which is that the beneficiaries have paid in part for their benefits by a special tax. But the benefits are now much larger than were paid for in this way. It seems inappropriate to leave these benefits untouched while we are cutting expenditures benefiting many needier persons. There are various ways of changing the social security programs that would significantly reduce the deficit. After many years in which social security benefits have been escalated by an exaggerated measure of inflation, some limitation of indexing for a period would be justifiable. A strong case can also be made for including one-half of social security benefits in taxable income, on the principle used in taxing private pensions.

I would like to urge that expenditures outside the field of entitlements not be neglected, even though the potential savings there are smaller. An excellent finding-list for such savings is provided by the Congressional Budget Office Report entitled "Reducing the Federal Deficit: Strategies and Options." It seems to me, for example, that there are opportunities to reduce expenditures for agricultural assistance and for export promotion that would be entirely consistent with the government's free market philosophy. Inclusion of such measures would help to strengthen the impression of even-handedness and fairness in dealing with the budget problems.

We are almost certainly not going to bring the budget into balance in the next three or four years without some significant tax increase. Even if that could be done it would probably not be desirable to do so. That is, some of the expenditure cuts that would be required would be more harmful than some tax increases. The revenues that may be needed can be raised in any of a variety of ways. My preference would be a combination of energy-related taxes and excises. For example, a gasoline tax of 50 cents a gallon would raise almost 50 billion dollars or an oil import fee of 5 dollars a barrel would raise almost 20 billion dollars. Such taxes would help to reduce dependence on foreign oil as well as raise revenue. Doubling the taxes on alcoholic beverages and tobacco would raise about $7 billion. Such a tax increase can be justified by the large expense the Federal budget now bears to provide medical care for the public. One merit of this general approach is that it would leave untouched the income tax rate cuts made last year and would not introduce unnecessary uncertainty into that aspect of the tax system where predictability is most important to most taxpayers.

Another category of revenue-increasing measures, either in addition to the excises or as alternatives to them, would increase the yield of the income tax without increasing the rates. This would include such measures as eliminating tax-exemption for industrial development bonds and terminating the deductibility of consumer interest payments.

Finally, although I should prefer not to go this route, we could defer the income tax rate cut scheduled to take effect in 1983. I would prefer not to do it because I think predictability of income tax rates is important. But we will have to give up some things we value, and I could not object strongly to giving up the 1983 tax cut. I thought the tax reduction in 1981 was much too large; we should be prepared to acknowledge that. As the President said, we should be judged not by our mistakes, for we will surely make more of them, but by how well we recover.

I have said nothing about the subjects economists are usually expected to talk about--the recession and how long it will last and whether inflation will continue declining. I have said nothing on those subjects because there is nothing important to say about them in connection with the work of this committee. We are in a recession and the inflation rate has come down. The future of the recession and of the inflation rate will depend primarily on the interaction between the

Federal Reserve and the private economy. If the Federal Reserve holds to a policy of monetary restraint and the private economy comes to accept the view that inflation is coming down to stay we will, not immediately but in a reasonable period, come out of our present travail into a condition of greater price stability and strong growth. If either of these conditions is absent--the Fed's persistence or the private sector's response--the course will be rockier. But there is little that the Federal budget can do about that. Budget policy should keep its eye on the long-term goals of defending the country while creating conditions favorable to durable growth and public harmony.

## TOWNSEND-GREENSPAN, INC.

### STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN, INC.

Chairman HATFIELD. Dr. Greenspan.

Dr. GREENSPAN. Thank you, Mr. Chairman.

The conventional forecasting wisdom, to which I generally subscribe, assumes a bottoming out of the slide in final demand in the period immediately ahead followed by a recovery in overall economic activity through the rest of the year and into 1983. Such a forecast assumes a continuation of the current moderate rate of inflation and at least some further decline in short- and long-term interest rates.

### EMPLOYMENT LEVELS IN JANUARY AND FEBRUARY

The data that were released today are somewhat ambiguous in the rebound of the unemployment rate of 8.8 percent, which was expected, and not terribly interesting. What is interesting is that payroll employment rose and hours of work rose rather significantly during the month of February, suggesting that the industrial production index which had fallen extremely sharply in the month of January largely as a consequence of weather has rebounded slightly in February and what might suggest, and I think erroneously, that that is the turn in the recovery. We do believe it will turn, but I don't think last month's numbers are it. Basically the incoming order series and various forward indicators of activity are still poor and that suggests that what we were looking at in the February data was largely a rebound from the abnormal effect of extreme winter weather during the month of January.

### INTEREST RATES

As the recession took hold late last year, long-term interest rates began to fall. The decline ended abruptly in early December, however, with the emergence of the first evidence that the long-term budget deficits were no longer under control but subject to progressive erosion. Following the leak of internal administration budget estimates of deficits of approximately $150 billion annually in the mid-1980's, the decline in long-term interest rates ended and rates turned back up in the midst of the most severe part of the recession. However, by the first week in January, the rise in rates seemed to be running into upside resistance despite the failure of any good news on the budget outlook to surface during the period. Since early January, long-term rates have seemed to first stabilize and then decline modestly suggesting that the notion of substantial out-year budget deficits is already largely discounted in current interest rate levels. There is an implication in long-term rates of a 10-percent-annual-average-inflation rate over the next decade. It is presumed that in order to finance the projected deficits, a politically sensitized Federal Reserve would be likely to create sufficient excess money growth to produce a 10-percent-annual-inflation rate.

Hence, any evidence that the size of the deficits will be less than some of the recently published depressingly large numbers is likely to bring long-term inflation premiums—and interest rates—down modestly. Given the widespread inclinations in the Congress to pare the deficit, I suspect such evidence will soon emerge.

In an earlier environment, given the recent improved short-term outlook for inflation, there would have been continued downward pressure on yield independent of the cyclical increase in the demand for funds. Were it not for the prospect of a persisting hemorrhage in the Federal sector, a substantial decline in interest rates would now probably be underway.

## INCREASE IN GNP

However, with large deficits confronting us and only a modest decline in interest rates on the horizon, I would expect gross national product—in constant 1972 dollars—to fall 1 percent in calendar 1982 compared with an increase of 2 percent in 1981. With the recovery accelerating in the second half of 1982, constant dollar GNP should show a 4-percent increase on a calendar year basis in 1983. However, although I believe a declining pattern of interest rates is still the most probable scenario for the next 2 years, the question must be asked: What if interest rates fail to come down or what if they continued to rise?

## INTEREST RATE CHANGES REFLECTED IN MORTGAGE MARKET

First, it is clear that the American economy in recent years has become increasingly sensitive to changes in interest rates. This largely reflects the emergence of a very large mortgage market as realized capital gains on homes have had to be financed in dimensions ranging from $50 to $100 billion annually. This has meant that, so far as the private sector is concerned, long-term interest rates have become a key factor in financing economic activity, not only for residential construction, but for the large amount of consumer purchases financed through the mortgage debt creation process as well.

As a consequence, one can envisage the rise in economic activity aborting relatively early with the levels of industrial activity either stagnating or actually declining until interest rates again softened—a pattern of stagnation interspersed with tepid business cycles of relatively short duration. In such an environment, the 1-year cycle of the 1980–81 period may not be atypical. Perhaps more important and of greater concern is the likelihood that should this form of cyclical activity become the general expectation, long-term capital investment projects could undergo major downward revision aggravating the underlying weakness in the economy. Over the longer run, this would lead to the chilling scenario of a gradually eroding economy interspersed with short-term cyclical behavior. This scenario could scarcely continue for very long without either a crack in long-term confidence and a decline into what would be generally described, even in today's jargon, as a depression. Alternatively, we could see a political response which could end up raising the level of inflation markedly higher in a futile endeavor to reflate the real economy.

The extreme form of this scenario still has a low probability, but it should no longer be put into the bizarre or "kooky" category. Should it come to pass, it would be characterized by huge budget deficits surpassing $200 billion annually. It would also have profound international economic repercussions.

## LONG-TERM EXPECTATIONS OF U.S. INFLATION

The root of the underlying problem of potential stagnation is the dramatic shift that has occurred in the long-term expectations of inflation in this country. Prior to the late 1970's, the general expectation for the United States was that inflation was either a wartime or an immediate postwar phenomenon that left to its own devices would gradually dissipate. As a consequence, the expected long-term average inflation rate embodied in long-term debt instruments was modest or nonexistent throughout most of American history. With the onset of gradually hemorrhaging Federal budgets and the inflation generating red ink associated with them, inflation forecasts gradually changed. When it became apparent in 1979 that the postoil embargo inflation was not unwinding, inflation forecasts jumped sharply. From mid-1979 to early 1980 long-term inflation forecasts surged, driving long-term interest rates up almost 5 percentage points where, with rather modest changes, they still reside. To avoid the prospect depicted above, either the long-term expectation of huge and growing Federal deficits must be altered or a major shift in private savings propensities to offset those deficits must occur. Neither alternative seems to be on the immediate horizon, as Professor Stein has just indicated, but growing political awareness of the dangers in the longer term outlook have and should continue to create countervailing forces which ultimately should lead to their solution.

If the Congress were to pass the President's budget and tax recommendation in total, the economic outlook would be far more favorable than appears at this time. To be sure, there are, as in all budgets, some optimistic assumptions unrelated to congressional actions. Hence, the President's recommendations, if implemented, will probably create a somewhat higher deficit than was reported in his budget message. Nonetheless, it would fall far short of the current fears of the financial community and surely far short of the deficit levels that are already discounted in long-term interest rates.

In any event, if actual receipts and outlays for fiscal 1983 through fiscal 1987 even roughly approximate those which are now projected in the President's budget, interest rates would fall substantially over the next several years, capital investment would be higher and recoveries in housing and, therefore, in autos and related materials businesses would be reasonably assured.

### VALIDITY OF PRESIDENT'S BUDGET

The President's budget, in my judgment, is a sensible set of recommendations that takes into consideration and balances the needs of national security and the economy.

This is not to say that it is the President's program or no other. There are inevitable value judgments applied to the construction of any Federal budget. Reasonable people can differ on priorities as well as degrees of risks to the economy and to national defense. But every variation from the President's program, lessening the budget deficit for example, creates problems for some other segment of our structure of goals and priorities. The choices are, as usual, between bad alternatives and worse.

### SLIMMING DOWN DEFENSE OUTLAYS

However, since I believe there is a bias toward deficits built into our fiscal process, we have to shoot for a much lower Federal budget deficit in the out years than we think can reasonably be absorbed by the economy. As a consequence, I would be willing to risk, and it is a risk indeed, slimming down the rate of growth in defense outlays.

It is extraordinarily difficult to know what is the right balance to insure our national security. We have to forecast not only the actions of our potential adversaries but the effectiveness of their weaponry and ours under conditions not experienced previously. We are also required to evaluate potential dangers which, if we are wrong in our judgments and responses, risk the continuation of our civilization.

There is almost no way to know the optimum strategic and tactical balance except to assume that the more resources we commit, other things being equal, the lower the military risk to this country. Nonetheless, the degree of security that this Nation has and its ability to maintain a viable defense establishment presupposes, as it has in past generations, a viable economy. In this respect I disagree with Professor Stein. There is clearly a trade-off, especially in today's environment between the Federal deficits, inflation, and economic viability on the one hand and the degree of military spending on the other. I have no idea how much can or should be cut from the defense budget. I am not privy to the latest security evaluations which one must surely be conversant with before making such judgments. I do, however, hope that it would be possible, without significantly increasing strategic risks, to lower the rate of growth in defense outlays. A restoration of the 7-percent real annual rate of growth recommended in President Reagan's defense budget last year would leave outlays, for example, for fiscal 1985 more than $20 billion less than currently projected. I do not imagine such a retrenchment would be easy to implement. One addresses specific programs and, needless to say, when we get involved in program-by-program, line-by-line budget analysis, what may appear at this stage to be in the Congress a large consensus for paring President Reagan's defense budget is surely going to be tested when individual programmatic changes are subject to deliberation.

### EFFECT ON DEFICIT OF INCREASED TAXES

It is by no means clear that increased taxes will bring the deficit down over the long run. The level of spending is clearly related to available funds, the only uncertainty is just how much the deficit is lowered per dollar of increased revenue. Over the long run I would suspect very little. The first year's receipts probably do reduce the deficit, but to an appreciably lesser extent in the out years.

I conclude that tax increases should be employed only as part of a package in which entitlement cuts are attached. Increased taxes in this exercise should be used to "buy" cuts in nondefense outlays. It is the only way that we can get deficits down over the long run.

### STATUS QUO OF INDIVIDUAL INCOME TAX

Accordingly, I would not recommend any alteration of the individual income tax changes embodied in the 1981 Revenue Act. They were addressed originally to offset the effects of inflation on individuals' taxes, that we have now dubbed "bracket creep." Without the tax cuts scheduled to go in place this year and next followed by indexing, the real tax burden of individuals, on average, would have risen. Tax receipts, as a percent of adjusted gross incomes, would have risen by approximately 1 percent per year over the next 5 years. The new legislation effectively prevents that from happening. If we rescind or delay part of the scheduled tax cuts we will in effect be acquiescing in increasing tax burdens on individuals. It strikes me that having solved one of the major problems confronting this country in the last year's legislation, it probably would be wise to go on to the next problem.

In summary, therefore, let me say that of all the various alternatives that I have seen, with respect to the budget process for the forthcoming year, I believe that the President has struck on the least worse solution to a very difficult set of problems. I suspect that as the Congress deliberates further this year, it will confront the same sort of seemingly impossible choices that the President has had to confront. The worst alternative at this stage, however, is to do nothing; that is, to allow expenditures to move on their current services path generating a budget deficit substantially in excess of $140 billion for fiscal 1983, with larger numbers in the out years.

Thank you, Mr. Chairman.

Chairman HATFIELD. Thank you, Dr. Greenspan.

## MASSACHUSETTS INSTITUTE OF TECHNOLOGY

## STATEMENT OF LESTER THUROW, PROFESSOR, MIT

### STATUS OF CORPORATE INVESTMENT

Chairman HATFIELD. Dr. Thurow.

Dr. THUROW. The fundamental inconsistencies of Reaganomics can be seen in its own self-proclaimed No. 1 economic goal—more investment. Last July the U.S. Congress for all intents and purposes abolished the corporate income tax. Eliminating the corporate income tax should have stimulated extra investment. Yet industrial investment in plant and equipment is now falling and widely expected to continue falling throughout 1982. The positive effects of changes in tax policy were more than offset by the negative effects of high interest rates and a recession. Because of the administration's monetary policies the de facto abolition of the corporate income tax did no good. Government revenue went down but society did not get the promised benefits in higher private investment.

### INADEQUATE SAVINGS

Think about the opposite side of the investment coin—inadequate savings. In 1981 personal savings were $107 billion. Deficits in the range now being planned more than wipe out all of personal savings. Yet this is what is being suggested by an administration pledged to raising American savings. Administrations who want to raise national savings run surpluses—not deficits. If the Reagan administration runs the deficits now being planned it destroys its own strategy—lower taxes—for raising savings. Whatever extra savings it gets from the personal tax cuts will be more than wiped out by the higher deficits.

### MAJOR ELEMENTS TO REAGANOMICS

There are three major elements to Reaganomics: tight monetary policies, large tax cuts, and a major defense buildup. Any one of these three elements could be achieved. With some luck and fast economic footwork perhaps two of these three elements could be achieved simultaneously. But it simply isn't possible to do all three of these items at the same time no matter how much that might be desired.

Economic priorities have to be established. If the defense increases planned over the next 5 years are necessary, then the United States needs to increase the taxes necessary to pay for them. If economic growth is the No. 1 priority, then monetary policies have to be adopted that are consistent with economic growth. If the priority is stopping inflation, taxes should be raised to avoid the rising deficits that the CBO is predicting 2 or 3 years down the line and defense spending should be slowed to reduce the inflationary bottlenecks that even the President's Council of Economic Advisers now admits will be created by the present military buildup.

Driving an economy with one foot slammed on the monetary brakes and the other slammed on the fiscal accelerator leads to the same results that it does when driving a car on an icy highway. The car simply slides into the ditch. And in the ditch is precisely where the American economy has landed with a recession likely to lead to the highest unemployment rates since the Great Depression.

## INCONSISTENCIES IN REAGANOMICS

America's economic problems will not be solved by tinkering with Reaganomics at the margin. As an economic strategy it is fatally flawed with inconsistencies.

To continue on the course outlined by the President in his budget is simply to continue on the course of the last 3 years. From the first quarter of 1979 to the first quarter of 1982 there has been essentially no real growth, only the ups and downs of recessions and abortive recoveries. With the present strategy we will simply continue that same course for another 3 years. Recoveries will occur, such as the one now predicted for mid to late 1982, but they won't lead to any sustained economic progress. Sooner or later, and probably sooner, tight monetary policies will throw the economy back into another recession.

If America is to shift from its current up and down performance onto a sustained path of economic recovery some major changes will be necessary.

## AMERICAN SAVINGS RATES

American savings rates, 5.3 percent in 1981, are not going to be brought into line with the 10 to 20 percent of the rest of the industrial world with trickle down, across-the-board tax cuts. To get the needed increases in savings we will have to reduce the availability of consumer credit, eliminate tax deductibility for consumer mortgage interest payments, and shift the tax system away from its current reliance on income taxes to a reliance on progressive consumption taxes. Taxes will have to be raised, not reduced, to permit surpluses in the budget.

To get real rates of interest down it will be necessary to flood the economy with savings. We should start by replacing the scheduled 1983 personal income tax cut with a system of unlimited Keogh accounts open to anyone for any purpose for any length of time. Such a change would instantly convert the Federal progressive income tax into a Federal progressive consumption tax. Tax rates should then be raised at high income levels to discourage consumption and encourage savings. With a substantial increase in savings it would be possible to let up on tight monetary policies and high interest rates without any danger of accelerating inflation.

## ELIMINATION OF CORPORATE INCOME TAX

The de facto back-door elimination of the corporate income tax should be replaced with a front-door elimination, but the change also needs to be paid for with the imposition of a progressive value-added tax or a large excise tax on gasoline sales of the order of magnitude now prevalent in Europe or Japan. An elimination of the corporate income tax based on accelerated depreciation and lease-backs is untenable. As far as the Federal Government is concerned the tax has been abolished since it will get little or no revenue. But as far as the country's efficient firms are concerned the corporate income tax still exists. When IMB buys a lease-back from Ford it is still paying taxes—they now just go to Ford rather than the Federal Government. Efficient firms simply pay their taxes to inefficient firms. But to eliminate lease-backs while keeping the present accelerated depreciation allowances would be to create an enormous tax incentive to counterproductive mergers. Last summer's corporate tax law simply has to be rewritten.

There is also a fundamental inconsistency between the Reagan administration's announced interest in economic growth and its civilian budget recommendations. No one can build a high quality economy out of low quality components. But this dictum applies just as much to the human component going into the economy as it does the investment component.

## AMERICAN LABOR FORCE

Six out of every 10 people who take the New York Telephone Co. competency test flunk it. Until 1981 the average test score on the scholastic aptitude test, the test given to college-bound seniors, had fallen for 18 consecutive years. The test score in 1981 did not go up, but at least it did not go down. The econony is perpetually short of skilled blue-collar workers such as machinists and tool and die makers. With a major military buildup underway, the shortages will increase from being acute to being critical. On a per capita basis we produce one-half as many engineers as the Japanese. Science education is collapsing in our schools as science and math teachers leave for better job opportunities in industry. The number of math teachers in the United States is now down 78 percent.

With a low quality, untrained labor force, how is America to compete in a scientific world filled with economic competitors who are our equals financially and technologically? To do nothing is to commit national economic suicide.

Yet the Reagan administration is dismantling the education and training programs of the Federal Government. Many of them were severely slashed last year and again this year. All of the physical investment in the world won't help the American economy unless we have a labor force well educated enough to use the sophisticated tools of tomorrow.

Any particular manpower program can be labeled a failure and abandoned, but manpower programs in general cannot be abandoned. The economy needs the skills that are not being produced. The individuals who are not being trained remain part of society. In the era of robots what is to become of a functionally illiterate, unskilled high school dropout? One can be hardnosed about poverty and illiteracy, but the hardnosed fact is that these unskilled people are going to be part of our society for the rest of their lives. And their children may very well carry on where they left off. In the education and training area every failure simply has to be replaced with another attempt until a successful approach is found.

### GOVERNMENTAL RESPONSIBILITY FOR EDUCATION AND TRAINING

Governmental responsibility for education and training was established more than 100 years before the New Deal. Social welfare programs may be a matter of ethics and generosity, but education and training are not. I pay taxes to help educate my neighbor's children not because I am generous, but because I cannot afford to live with them uneducated. And since people can vote with their feet, as the President recently has urged them to do, the Federal Government cannot afford to leave education and training to either private individuals or State and local governments.

It is strange that an administration pledged to supply side economics designed to speed up the economy and praising the virtues of individualism seems to think that the human component is unimportant when it comes to economic success. But whatever the cause of this psychological quirk, it is not a quirk with which the country can afford to live.

Chairman HATFIELD. Thank you, Dr. Thurow.

### RESULTS OF CURRENT DEFENSE BUILDUP

Well, we have a variety of viewpoints presented in this panel, and it is very stimulating, very provocative, and very helpful.

I would like to ask Dr. Stein a question. You have strongly supported the President's defense buildup. I would like to refer to several statements from President Reagan's economic report of February 1982 in which three results are anticipated from the largest defense buildup in peacetime history.

No. 1, a substantial transfer of resources in the durable sector to defense production may increase relative prices in some of the affected industries. Both the Department of Defense and private purchasers may have to pay more for goods from these industries.

No. 2, increased demand may produce delays in the delivery of military goods, thus driving up the cost of high technology weaponry. I would note here that average cost growth for major weapons systems exceeds 3.5 percent per year, exclusive of inflation.

The third potential impact, according to the report is a temporary crowding out of private investment. Defense procurement and associated production of equipment use many of the same physical resources needed for private investment in civilian produced durables.

Those are three observations made by President Reagan's council which has given him this analysis. I really would just like to have you comment in light of your thesis. How would you analyze these conclusions? Would you agree with these points?

Dr. STEIN. I guess my first comment is that having participated in the writing of those reports I do not regard them as the Bible. All that is being said there is that defending the country has cost. Nobody ever said it is free and cheap. But it is worthwhile. Of course, to say that increasing the share of the national income that is devoted to defense is going to increase the relative prices in the defense industries, which implies reducing the relative prices in other industries, is a perfectly clear description of the way the American economy operates. If you increase the share of the national income that goes to the hospitals you are going to increase the relative cost of medical care and reduce the relative cost of other things. There is nothing wrong with that. There may be some increase in real cost involved in building the defense program up quickly. But, of course, time is important. We could probably get aircraft quicker if we planned to get them 10 years from now rather than 5 years. Ten years from now we may not be in business. They may not do us any good. So there is no point to that. But also, it is not, as I say, necessarily the case because in a large part of the defense industry increasing the rate of purchase will reduce cost. You will get closer to the economies of scale, closer to the capacity of existing facilities, and you will produce things more cheaply than quickly.

As for crowding out investment, that depends on how you finance the expenditures. If you finance by a deficit you will crowd out private investment. If you finance by taxes which bear on consumption, you will not crowd out private investment. So I think those points in the economic report are probably in general correct, but rather trivial objections to defending the country.

### DEFINITION OF NATIONAL DEFENSE

Chairman HATFIELD. Dr. Stein, I suppose really what this whole question begs is our definition of national defense or security. I read from your testimony you see it primarily in terms of hardware and the Pentagon military institution. I am sure you recall President Eisenhower's dissertation on the defense of the Nation, a five-star general who recognized that housing, nutrition, education, health services were as fundamental a part of the national security as was military hardware—not an either/or but a balance. And President Eisenhower warned us that sometime we will reach a point where spending more dollars for bombs and rockets will actually weaken our national security if there are these other human needs not being met, or that we see a weakening of our infrastructure.

Are you aware of what is happening to the infrastructure of this Nation vis-a-vis housing, vis-a-vis the attack on communicable diseases, vis-a-vis the reduction of opportunities of education? Do you not consider these fundamental to our national security?

Dr. STEIN. They are important for our national security. What you have to ask yourself is in what aspect of our society and life are we relatively weak. We are enormously better housed, enormously better provided with health services, enormously better educated than we were when President Eisenhower made his remarks about the military industrial complex. Vis-a-vis our potential adversary we are enormously weaker. So what we have to ask ourselves is where is the problem? Our problem is not the American people do not have sufficiently high incomes or sufficiently high education. Our problem is we don't have the hardware.

## QUANTITATIVE ARMS RACE WITH U.S.S.R.

Chairman HATFIELD. Well, Dr. Stein, I would argue that with you because I think all the studies or all the arguments I have heard have been totally restricted to quantitative analysis, and I think that is terribly misleading. It was the number of launchers we heard of first. We heard the Soviets have a number, therefore we had to go and build a number. Then we find it is not the number of launchers it is the number of warheads you have. It is not just the number of warheads, it is the accuracy of the warheads. I have seen very little qualitative analysis given to this. I think these fears and scare tactics to justify $1,600 billion on an economic industrial base that is faltering, that is in such dire need of upgrading and retooling and modernization, are absurd. First of all, I don't think our industrial base can produce the military goods and services. Second, we are in the process of Sovietizing our economy in so doing because we are denying the civilian market those goods and services that would otherwise be produced. And we are inviting more imports, which in turn creates more unemployment.

To me it is just indefensible. I believe this is what the Shah of Iran thought. Put all your eggs in the military hardware basket. And let's remember too we have to analyze our would-be adversary. He is not 10 feet tall, and I don't think we have done an accurate analysis there.

I am really somewhat shocked by the line that you take, that somehow the only way that capitalism can survive is going to be on a war-based economy. That is what you are saying.

## STRENGTH OF U.S. ECONOMY

Dr. STEIN. Absolutely not. Mr. Chairman, you discourage me enormously.

I cannot argue with you about the accuracy of our weapons and so on, but as for the description of the American economy as being in such a rocky state and being in the state where it does not meet the needs of the American people and, in Dr. Greenspan's word is, possibly not viable, that is absolutely a fantasy. We have here the strongest economy in the world. We have our economic problems. Solving of those problems does not require unilateral disarmament.

Now if you are concerned about the effects of the defense program on private investment, then you should raise taxes, which is what I propose, and provide the funds so that the defense program can be financed without large deficits, therefore without depressing private investment. You talk about Sovietizing the American economy. We are talking about the difference between spending 5.5 percent of our GNP and spending 7 percent of our GNP on defense. That 93 percent of GNP that is available for nondefense in 1985 will be larger than the total GNP we have now or ever had before. If an economy like ours cannot afford to spend 7 percent of its national output to defend itself we are really in terrible shape. But we are not. Our great lack is lack of will and foresight, and I get very bad evidence of that here today.

## LACK OF READINESS IN U.S. MILITARY

Chairman HATFIELD. I appreciate your response. I am not suggesting that the alternative is unilateral disarmament. I am not a unilateral disarmamentist. When the Chief of Naval Operations tells me he can't put to sea all the ships under commission in the U.S. Navy, and there is other evidence of lack of readiness in our military, and we continue to permit ourselves to be mesmerized by exotic weapons that create such cost factors, I can't help but come back to the fundamental question, what is national security? I think it is more than a military question. I think it is more than military megatons. Having just finished reading "The Last Years of Robert E. Lee" and the new book on Ulysses S. Grant, I go back to our own Civil War period to really give credence to my perspective that it takes more than hardware, and it takes a productive economy. The South didn't lose the war because of the lack of military strategists; the South lost the war because it didn't have the industrial productive base.

Dr. STEIN. The difference between us and the Soviets is not in our industrial productive base, the difference is in their military hardware. Of course national security is more than military hardware. But you have to ask what is it we are lacking, and what we are lacking is the hardware, not the industrial base.

Chairman HATFIELD. Thank you very much.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman. Let me say, Mr. Chairman, that I agree with many of your remarks and comments in many areas, but particularly the one about the War Between the States. We in the South know we didn't lose that war because of our generals, we lost it because we didn't have the productive base to get them the materials that they needed.

## ECONOMIC PROBLEMS AMONG WORLD POWERS

Dr. Stein, I would like to address a question to you and perhaps Dr. Greenspan. I have been concerned for some time about the problems that we are having economically. We look at the problems that the Soviet Union is having economically. They have terrible problems. They can't feed their population. I read just the other day that there is actually hunger outside some of the major cities in the Soviet Union. We look at the economic problems of the United Kingdom that have been existent since perhaps prior to World War II, but certainly have accelerated since World War II. And then you look at the defense expenditures as a percentage of GNP that goes into defense buildup on the part of the Soviet Union, the United States, the United Kingdom. And then on the other side of the coin you look at Japan and perhaps even the Federal Republic of Germany. The Japanese put almost none of their GNP into defense and the Germans put much less than we do. They have accelerated that in recent years.

## WEAPONRY PRODUCTION AND DECLINE IN PRODUCTIVITY

I suppose my question to you, do you see any correlation between the amount of our national wealth that goes into the production of weaponry and the decline of productivity in our economy, in that of the United Kingdom and that of the Soviet Union?

Dr. STEIN. Well, I would say no. In fact, our productivity performance in the United States has been worse during precisely the period in which we have been reducing the share of the GNP going for defense. But I would not make the contrary argument that big defense production is good for the economy or productivity. It is a burden on the economy, but it is a burden we have to bear and it is not a very heavy burden. But as for these international aspects, somebody wrote an article in the New York Times on that, to which I wrote a reply saying you would get a better correlation between the proportion of the population graduating from the Harvard Business School and the decline of productivity growth than between the share of the GNP spent for defense and the decline of productivity growth. As Dr. Schultze said, those one-dimensional correlations prove nothing. The story of the decline of U.S. productivity is a long one, but it has not very much to do with our national security effort.

Senator SASSER. Would you like to add anything, Dr. Greenspan?

## PRODUCTIVITY MEASURE

Dr. GREENSPAN. I would, except my knowledge of the Harvard Business School graduate correlation is weak.

Remember when we measure productivity we include defense production in the data. It is obvious the larger the proportion of defense one has in one's GNP, which is essentially an insurance policy, the less one has in consumer goods and private investment goods. But that is merely a fact of the arithmetic involved. But I would agree with Dr. Stein. I don't find any relationship between the relative trends in productivity and the share of military expenditures to GNP, either through time or in international comparisons.

Senator SASSER. Perhaps you are right. It just worries me somewhat when I think of all those tanks rusting in the jungle of Vietnam that were built here, and the Japanese were building robots to compete with us domestically and we were providing the protection to allow the Japanese to do that. I suppose somebody has got to do it.

Dr. STEIN. May I make a comment. Since reference has been made to the wisdom of President Eisenhower, I should point out that during President Eisenhower's administration we spent something like 9 percent of GNP on defense. We had an economic performance which was the marvel of the world, and we are now talking the maximum under the President's program of getting the proportion of GNP back up to about 7.3 percent in 1987.

## PROPOSED REVISION IN MONETARY POLICY

Senator SASSER. Dr. Thurow, in a recent article in The Economist you contend that we must make major gains in productivity to hold down inflation and to spur economic growth. You said in your testimony that stable investment and stable interest rates, lower interest rates, is the key to higher productivity. How would you suggest we revise monetary policy to move in the direction of lower real interest rates and stable interest rates in order that we can move foward and have higher productivity?

Dr. THUROW. Well, I basically subscribe to the arguments being made by Charlie Schultze. We need a tax increase to lower the Federal deficit and to allow monetary policies to either produce lower interest with the same monetary policy or to have slightly easier money supply growth.

When you think about shifting to higher taxes I think—and this connects to the defense business—the thing to remember about the MX missile is consumption. Economically, an MX missle is a toaster, and if you are going to have a big buildup of MX's, then you have to reduce the number of toasters you are buying in the economy. If you want further increases in investment at the same time we should be shifting the taxes toward consumption taxes.

## INCREASED GASOLINE TAX

I also agree with Dr. Stein here we ought to have a big gasoline tax in the United States. In European countries it is now at the level of $2 a gallon. He talks about 50 cents a gallon. Two dollars per gallon would raise the kind of money that would eliminate the deficit and allow you to pay for your defense buildup, and it would focus the tax system on consumption.

I think it is a mistake for economists to get into a debate on military policy. We ought to stick to the problem of what do military policies do to the economy. But I think the important thing is that defense is consumption. If you want to stop it from having adverse effects on the deficit then you have to make sure you have a tax system that leans very hard on private consumption to make room for that public consumption called national defense. So I subscribe to the general idea we need higher taxes in the United States; they should be higher consumption taxes and we should use that to buy lower interest rates.

Senator SASSER. My time is up, Mr. Chairman. I have more questions. I hope we will have another go-around.

Chairman HATFIELD. Yes.

Senator Rudman.

Senator RUDMAN. Thank you, Mr. Chairman.

## CYCLES IN AMERICAN ECONOMY

Dr. Greenspan, in your testimony here this morning you describe the scenario of the American economy going through cycles of—I think you use the word "tepid cycles of relative short duration interspersed with stagnation of the economy." And then you follow it with this statement;

"The extreme form of this scenario still has a low probability, but it should no longer be put into the bizarre or 'kooky' category. Should it come to pass, it would be characterized by huge budget deficits surpassing $200 billion annually. It would also have profound international economic repercussions."

While I guess the difference between your analysis and that of Mr. Sinai of Data Resources is that, from what I can understand from what he has written, he does not feel that budget deficits exceeding $200 billion annually are that unlikely without very strikingly swift and courageous action by the Congress in the area of fiscal policy. With that in mind, I want to ask you this question.

## ALTERNATE BUDGET PROGRAMS

Senator Domenici, Chairman of the Senate Budget Committee, and I would assume you have appeared before his committee, has made a proposal I am sure you are familiar with. As you say in your statement, there are other possibilities other than the President's program. Senator Domenici's tends to be a more cautious program so as to insure these enormous deficits don't occur. It is a combination of modest decreases in defense spending, which you yourself indicate is something we at least ought to consider, a very strikingly reduced rate of growth of the entitlement programs, and some changes in the tax structure. Facing what everyone speaks of as either a low risk or high risk but a real risk, namely economic catastrophe—even though we disagree on the levels of the probability—wouldn't it be probably prudent to follow Senator Domenici's proposal so you don't have the economy accelerating into a downturn so rapidly that nothing we do at that point could have a substantial effect?

Dr. GREENSPAN. Well, Senator, I would put my priorities as follows: As I said in my prepared testimony, I would prefer of all the alternatives I have seen the program presented by the President. I would obviously prefer Senator Domenici's program to doing nothing.

The difficulty I have with any program spelled out in the level of detail which I have seen it is that it is still too general, and the problem of evaluating any particular program is always that until you see line-by-line and the full budget detail it is not easy to basically make some judgments. But there is no question that compared to doing nothing Senator Domenici's program is far superior.

Senator RUDMAN. Let me carry that just a bit further, Dr. Greenspan. Much of what you have said parallels some of the things that I draw from reading various CBO estimates. But there is one essential difference it seems to me. I guess I disagree with this. CBO estimates that if we do precisely what the President is asking us to do, which is what you are suggesting, rather than having a decreasing deficit, we are going to have a scenario of increasing deficits. As a matter of fact, there are some pretty respected people around here who do some pretty accurate work who say the 1982 deficit will be more in the area of $130 billion and 1983 will be closer to $150 billion, that 1984 and 1985 will be $180 billion, which is getting perilously close to your $200 billion figure. It seems to me that CBO has historically been reasonably accurate. Evidently you don't agree with their figures.

Dr. GREENSPAN. That is correct, Senator.

Senator RUDMAN. Could you tell me why?

Dr. GREENSPAN. Sure. First of all let me say I think that in our evaluation of the fiscal 1982 budget analysis we are missing one set of statistics, which is what has happened so far. We are now in the sixth month of the fiscal year. As best I can judge, through the first 5 months the deficit was at a seasonally adjusted annual rate of $65 billion. It is very obvious that one, receipts are coming in above budget projections for reasons nobody yet fully understands, and two, outlays are running under projections largely as a consequence of defense running short of programs. I think the likelihood, if anything, is that the budget deficit for 1982 may end up below the President's budget estimate, and the numbers of $108 and $110 billion for this year I think are a bit off the mark.

Now that doesn't answer the other question, which is whether or not we get widening deficits under the CBO forecast. I think not. I think the rate of interest they have implied in their particular budget document, which is this document right here, is too high in the context of the Congress passing the President's full program.

Senator RUDMAN. I thank you, Dr. Greenspan, for that bit of bright light on Friday.

Mr. Chairman, I will say to you publicly what I said privately. I would prefer in the future if you scheduled hearings other than Friday. I think it does raise havoc with one's weekend.

Chairman HATFIELD. We will just take a few moments more. Let me pick up where Senator Rudman left off. Dr. Greenspan, when we talk about the President's plan or his proposal for 1983, let me just outline to you a few statistics that we are dealing with which I think would indicate that the plan is not very politically realistic.

### PROPOSED BUDGET CUTS

First of all, the President's 1983 projected deficit in his budget is predicated upon actions taken by the Congress and agencies over which he has authority. That deficit reduction package amounts up to approximately $56 billion. Part of it deals with further reductions in the nondefense discretionary portion of the budget, which by the way, comprises only about 5 or 6 percent of total budget outlays. Let's look at that baseline for just 1 second. That total deficit figure is $91.5 billion out of a $758 billion outlay projection for 1983. We are going to be paying $112.5 billion in servicing the national debt. Now, we could abolish all those nondefense discretionary funds and still not balance the budget. And it has moved beyond the point of paring these programs. For fiscal year 1981, we rescinded over $14 billion from those nondefense discretionary funds and then turned right around and added $12 billion in supplementals for the Defense Department. In the reconciliation package we cut a further $25 billion from that 4 to 5 to 6 percent of the total base. Now we are being asked to cut $14 billion more in 1983.

The preliminary estimate of the Republican-controlled Senate of the United States, of the authorizing committees, on the 1983 authorization levels is somewhere between $20 and $40 billion over the President's request and the President is asking us to reduce the discretionary programs by $14 billion.

Now I am only outlining these in terms of political reality. Senator Dole says he has a 20-member committee, 11 of whom are up for reelection in 1982. So here is the major committee dealing with entitlements. This may be the "least worst scenario," but I am not sure, frankly, that the President's budget politically can fly in the Congress of the United States. I don't know what will emerge as an alternative. But what, in light of the scenario that I have outlined would you suggest in terms of reaching the President's goals? The Republicans of the Senate who are in the leadership roles of these committees are very much wedded to the relationship we have with President Reagan. The President can't do anything alone and neither can the Congress. We have to resolve these differences. What would be not the least worst scenario, but rather an alternative scenario in your perspective of how we can get control of our fiscal household? Dr. Thurow mentioned not getting results out of the tax investment credit, capital gains, tax decreases, and other provisions we have enacted. In talking to Wall Street and the money market, two major escalators in the budget picture, namely, military spending and entitlements, are perceived as still not being under control.

### SUCCESS OF PRESIDENT'S BUDGET CUTS

Dr. GREENSPAN. Mr. Chairman, I would scarcely want to argue the probabilities of whether it is a politically viable projection. I think my recollection was I had very much the same attitude a year ago when the President sent up cuts of $35 billion. I said I can't believe it will make any progress whatsoever. I was shocked and delighted by the consequences of the results.

Chairman HATFIELD. We did deliver, though, in the Congress on the President's request. Let me tell you, this committee had to do the whole operation without the benefit of anesthetic. We did the amputations, we did the surgery on those reductions on a 5-percent basis by $14 billion and then another $25 billion as well.

Dr. GREENSPAN. Mr. Chairman, I think that was a very important contribution to the long-term stability of this country.

Chairman HATFIELD. It was all consumed by the military. Everything we cut practically was transferred over to increase military spending, which is the least economically stimulative dollar we put in any part of the economy.

Dr. GREENSPAN. You can also say it was picked up by increased interest payments. There are other aspects of the budget which clearly increased as a result.

The problem that I have with making political judgments before I make economic ones is I come up here and tell you what I think will be politically feasible and you will send me home, as indeed you should. I don't know or shouldn't really make judgments on the political feasibility before a particular package——

Chairman HATFIELD. I wasn't really asking for political judgment as much as an alternative economic package.

Dr. GREENSPAN. I think that, one, we allowed our Military Establishment to erode subsequent to Vietnam, and I think a major buildup is clearly required. I do not happen to think looking at the delivery schedules on various different types of hardware that the difference between a 7-percent growth in total and 9 percent strikes me as significantly altering the shape of the window of vulnerability. As a consequence of that, I would prefer that we recognize that there are major inflationary problems potentially out there which could undercut the American economy. And since I envisage our ability to stay ahead of the Soviets rests on our technological know-how and our ability to have continuously advanced technology, I view the health of our national econony as a critical military security question, not in the human resources way which you raise the issue, although I cannot obviously disagree with that, I am thinking strictly in terms of industrial and technological infrastructure which I think is at the base of our ability to produce new weapons system of highly superior form. So what I would conclude is we have to get the deficits down. I think that, as I indicated in my prepared testimony, raising taxes is not self-evidently a procedure which will accomplish that. If one seeks increased revenues it should be in a form in which you bring the rate of aggregative spending down. And I would agree that it does imply that spending growth must be slowed in both the military and in entitlement programs that are now currently under consideration.

Chairman HATFIELD. Thank you.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

## SPECTER OF WORLDWIDE DEPRESSION

I want to direct one final question to Dr. Thurow. I am very concerned about the long-term health of our economy. We hear testimony today from Dr. Greenspan and other well-known economists we are in a recession now, we may have recovery, we will have recovery, it will be a short-term recovery followed by recession. I hear that over and over again—recession, short-term recovery, it doesn't last long, recovery is not deep, followed by another recession. We seem to be wallowing from recession to recession. And now respected economists are saying that the possibility of a depression is not out of the question any more. Dr. Greenspan has said this morning that that is no longer a "kooky" idea, that we could have a world depression. The Chancellor of West Germany, Helmut Schmidt, has raised that specter himself, concerned about world depression.

Our economy is getting old. The basic structure is getting old. It doesn't appear to be very productive any more. Our managers don't appear to have the will to make the changes that need to be made and to share the burden with some of us in the Government. And some in labor also don't appear to have the will to make the necessary, hard adjustments that perhaps we are going to have to make to get this economy going again, and not just for 1 year or 2 years but I am talking about the decades.

### HUMAN DEVELOPMENT PROGRAMS

Dr. Thurow, you talk about getting us going in the way of human development programs that we ought to be supporting in order to keep our economic growth moving. I couldn't agree with you more. I am concerned about the fact that Japan is producing, as I understand, more engineers than the United States of America is. Our population is much larger than theirs, and I think our need for engineers is much larger.

My question to you is could you spell out what you think are some of the most important human development programs that we ought to be supporting in this country in order to look toward economic growth in an increasingly technically advanced world, and as you go, at the risk of sounding partisan—I don't mean to be—but as you go would you spell out the criticisms of the Reagan budget that you see are counterproductive in this regard?

Dr. THUROW. You can't get a high quality economy with low quality components. Improving one component isn't going to do it. I think this is one of the places you need a bipartisan strategy because it isn't going to be done in 4 years, therefore it has to be something that will carry across Republicans and Democrats and will carry across administrations.

### SAVING AND INVESTMENT IN TECHNOLOGY

For example, there is no doubt we need more saving and investment in technology. The Japanese have 70 percent of all robots in the world, and as long as they do so they are going to beat us. There is no question we need a higher quality component on investment.

If you look at the human dimension I think you need a higher human component going into the economy. The same is true on research and development. In terms of civilian research and development we are being outspent as a percentage of GNP by both the Germans and the Japanese. The same is true in infrastrutures—bridges, roads, ports. You don't run a productive economy on a low-quality infrastructure.

A friend of mine from Europe recently came to visit me and he made a tour around the country. And he was visiting me in Boston and he said, "How come the country is all rusty"? Well, America is rusty if you see the bridges and highways.

You have to have a strategy for dealing with all of those.

### U.S. FAILURE TO TRAIN SKILLED BLUE-COLLAR WORKERS

If you look at the human component, if I list the priorities, I think our biggest deficiency is our lack of system for training skilled blue-collar workers, the machinists, and tool and die makers. That is the place where the economy runs into shortages first. If you are in a booming economy, when we have a recovery, what workers do we run out of first? These are the people.

There are two ways of getting those people. One, you can do it like the Japanese with lifetime employment. Their companies take the responsibility for training because the people can't quit. The other way is the way the Germans do it, where you have a large government apprentice program. The way we have done it in the United States because we are richer is we bought those people from the rest of the world. Not too long ago at MIT, where we employ a lot of skilled blue-collar workers in our labs, they did a survey as to where those people came from because they were all 55 years of age and they were going to retire. The answer is they all came from Germany, because when they came 30 years ago wages were a lot higher in the United States than in Germany so you could take your German training to the United States and make a very high income relative to Germany. Of course, right now German wages are higher than American wages. Nobody is going to come to America to get higher wages. So that source of supply isn't there.

Yet the apprenticeship programs in this budget, which have nothing to do with poverty or college loans, they are part of what is supposed to be cut. I don't think we are going to have a viable economy, and that is particularly true in a military buildup, because those are the people that are in short supply when you get into a miltary buildup.

### SCIENTIFIC MANPOWER SUPPLY CRISIS

We have a real crisis in scientific manpower. You mentioned we are being out-produced on engineers, which I made reference to in my testimony. Essentially science education in our high schools is dissolving because anybody with a science degree can get a much better job at much higher wage rates in industry. Seventy-eight percent of all math teachers in the last 10 years have disappeared. Sixty-four percent of all science teachers have disappeared.

I was in Dallas, Tex., the other day and the superintendent of the Dallas school system told me he had 100 high schools and junior highs without a single qualified math teacher. Somebody was teaching mathematics but they did not have a degree and weren't qualified under Texas law to teach mathematics. That is cannibalism in the sense if you don't take high school physics and math you are not going to ever get to MIT and places like that, and we are never going to have the high skilled manpower necessary for defense industries and civilian recovery. Yet right across the board we are getting cuts.

A lot of these programs failed. I am perfectly willing to accept that. But for everyone that failed there should be attempts at replacement.

Senator RUDMAN. Let me make one observation. There is one part of what you said I think is accurate. The reason they don't have them in Dallas or New Hampshire or Oregon and Tennessee has nothing to do with what we are doing. It is the fact that the local school districts refuse to pay these teachers what they are worth to keep them in most instances. I haven't heard anyone suggest Federal supplements to teachers of math and science. But I know in the area I live, which is near you, we have a high tech area around New Hampshire and Massachusetts. You touched on the science teachers, and it is true they are going into private industry because of plain economics.

Dr. THUROW. Let me remind it wasn't too long ago you had programs to encourage that. The National Defense Education Act was adopted after the Sputnik shot in 1957 which subsidized school systems to have science teachers, language teachers. That has been phased out.

Senator RUDMAN. But not the extent the wage gap exists.

Dr. THUROW. There is no question of that. But the whole point is if State and local governments don't solve that problem we as a Nation somehow have to solve it. You can't simply say let science and education dissolve. What I described in Dallas, the same is true in Boston. I was at a Boston high school recently. They at one time had 13 math teachers. They are now down to one. I almost wanted to ask the guy why are you so stupid as to stay?

Science education is also dissolving in our liberal arts colleges. That is something that you have to have an answer to. You can't just say well, the town of Portsmouth, N.H., should solve the problem. The fact is Portsmouth and Dallas and Boston are not solving the problem. Somehow it has got to be solved.

Senator SASSER. Thank you, Dr. Thurow.

Chairman HATFIELD. Thank you very much, gentlemen. You have been very helpful. I can't express my appreciation too strongly to each of you for your contribution. I think the diversity is part of the strength of this country. And the diversity among economists not only confuses us politicians but it also focuses our attention on some very important points this committee has to deal with. I want to thank you again very sincerely from each member of the committee. The record will be circulated widely so that members who were not able to be here will have the opportunity to have the benefit of your questions and answers.

I think we ought to ask if there is anyone who has one last comment he wants to get off his chest? It has been a good exchange. I hope it has been on the basis of our views and perspectives, and our biases and prejudices, not on the basis of anything personal. But if there is anyone who wants to make one last comment, please do so. Dr. Stein, I think you would like to.

Dr. STEIN. I do feel obliged to say that the present financial difficulty in which you find yourself was not unexpected and the Congress cannot say it is the innocent victim. After all, you did make a $150 billion tax cut last year, which is the source of a great deal of difficulty.

Chairman HATFIELD. Dr. Stein, I would say also the President has said he does not spend one penny that is not appropriated by the Congress or enacted through entitlements. We certainly bear a great responsibility for the economic dilemma. As I said earlier, it will take both the executive and legislative branches working in harmony to work out the solutions. I think you will find there is on both sides of this committee, the Democratic side and the Republican side, a desire to help the President to find the solution and to have an input in what that ultimate solution will be.

## CONCLUSION OF HEARINGS

It has been very helpful to have you here this morning. Thank you very much. This concludes the economic overview hearings. The committee will recess, subject to the call of the Chair.

[Whereupon, at 11:50 a.m., Friday, March 5, the hearings were concluded, and the committee was recessed, to reconvene at the call of the Chair.]

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